[2013] UKFTT 642 (TC)

TC03026

Appeal numbers: TC/2012/5569, TC/2012/5558, TC/2012/5563 & TC/2010/5227

CORPORATION TAX – tax avoidance scheme designed to achieve loan relationship debit in borrowing company in a group without a corresponding tax charge in any other group company – loan structured to provide a return in the form of preference shares issued by the borrower, not to the lender but to another group company (the share recipient)
Lead case issues: (1) was the lender taxable under FA 1996 (loan relationships)- application of FRS 5 to the accounts of the lender – was the lender taxable under s 786 ICTA – effect of s 80(5) FA 1996; (2) was the share recipient taxable on its receipt of the preference shares under Case VI of Schedule D; and (3) on the limited basis of the question put to the tribunal, did the unallowable purposes rule in FA 1996, Sch 9, para 13 result in the borrower's debit in respect of the issue of the preference shares under the loan agreement not being taken into account under FA 1996

FIRST-TIER TRIBUNAL
TAX CHAMBER

VERSTEEGH LIMITED
NESTRON LIMITED
SPRITEBEAM LIMITED
PROWTING LIMITED **Appellants**

- and -

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

TRIBUNAL: JUDGE ROGER BERNER
JUDGE GUY BRANNAN

Sitting in public at 45 Bedford Square, London WC1 on 23 – 26 September 2013

Kevin Prosser QC and James Henderson, instructed by PricewaterhouseCoopers Legal LLP, for the Appellants

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

DECISION

1. A number of groups of companies have entered into a scheme designed to achieve a corporation tax deduction in one group company for the costs of an intra-group borrowing, but without any concomitant taxable accrual or receipt in the group company making the loan, or in any other group company.

2. HMRC seek to challenge the effectiveness of that scheme on a number of grounds. These appeals are lead cases for those groups who have undertaken the scheme, which is very simple to explain. One group company ("the Lender") made a loan to another group company ("the Borrower"). The terms of the loan required repayment of the principal to the Lender, and obliged the Borrower to issue irredeemable preference shares ("the Shares"), in an amount equivalent to a market rate of interest on the sum lent for the period of the loan, not to the Lender but to another group company ("the Share Recipient"). The loan was repaid at the end of the loan period, and the Shares were issued by the Borrower to the Share Recipient. The financial statements of the Lender for the relevant year, that ended 31 December 2003 ("the Accounts"), did not recognise any interest income or other profit on the Loan.

3. In this lead case appeal, three of the appellants are members of the Commercial Estates group: Versteegh Limited was the Lender, Nestron Limited was the Borrower and Spritebeam Limited was the Share Recipient. For ease of recognition we shall use those descriptions, rather than the company names, throughout this decision. The fourth appellant, Prowting Limited ("Prowting"), is a member of another group (the Westbury group) that undertook the scheme. It was in the same position as the Share Recipient, and has been included as a lead case only because there was a difference in accounting treatment between it and Spritebeam Limited. However, nothing turns on that, and we shall therefore refer only to Spritebeam Limited as the Share Recipient.

The issues in these appeals

4. Under rule 18 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 ("the Tribunal Rules"), the following are the common or related issues:

(1) regarding the Lender, whether the value of the Shares issued to the Share Recipient forms part of the profits of the Lender:

(a) under Chapter 2 of Part 4 to the Finance Act 1996 ("FA 1996") (loan relationships), on the ground that the Accounts are incorrect in that the correct and only application of GAAP required the Lender to recognise interest income on the Loan; or

(b) under s 786(5) of the Income and Corporation Taxes Act 1988 ("ICTA");

(2) regarding the Share Recipient, if (but only if) the answer to (1) is No, then whether the value of the Shares forms part of the profits of the Share Recipient:

(a) under Case III of Schedule D [that argument was not pursued by HMRC in this appeal]; or

(b) under Case VI of Schedule D; and

(3) regarding the Borrower, and irrespective of the answers to (1) and (2), whether para 13, Sch 9 FA 1996 applies to the debtor relationship of the Borrower so that the Borrower may not bring into account any debit in respect of the Loan under the loan relationships rules.

5. In relation to the Lender, the argument on the application of s 786 ICTA was an alternative to the argument on the question of the proper accounting in the Accounts of the Lender. It is only if we were to decide the accounting question in favour of the Lender that the application of s 786 to the Lender would arise. If we decide that the Lender is taxable on either of those two bases, the issue of the tax liability of the Share Recipient will fall away. On the other hand, the para 13 issue (unallowable purposes) in relation to the Borrower is pursued whatever the outcome of the cases in respect of the Lender and the Share Recipient.

6. We should at the outset say a little more about issue (3), the para 13 issue. The parties have agreed that the question put to the tribunal is narrow in scope, and requires no further findings of fact by the tribunal. Instead the question is put in the following way:

(1) Whether it necessarily follows that the Borrower has a tax avoidance purpose which is a main purpose within the meaning of para 13, Sch 9 FA 1996 where, as in this case,

(a) the only reason for the borrowing's design structure or its terms was to obtain a tax advantage for the Lender and/or the Share Recipient (in that the entirety of any payments made by the Borrower would escape tax altogether in the hands of the Lender and the Share Recipient),

(b) the Lender, the Share Recipient and the Borrower all knew at the time of entering into the borrowing that the borrowing was designed and structured so that the Lender and/or the Share Recipient would obtain the tax advantage,

and irrespective of the further fact that the Borrower had a commercial need for the borrowing, and irrespective also of any additional facts, whatever they may be, including for example that the Borrower was not able to obtain the funds from any other source, and the Lender was not willing to provide funding on any other terms, and the Borrower would not obtain any financial or other benefit from the accrual of the tax advantage to the Lender or the Share Recipient (the Borrower having no shareholding or other interest in the Lender or the Share Recipient), and there was a cash flow advantage to the Borrower in issuing shares instead of paying interest in cash.

(2) If the answer to (1) is yes, whether the facts in paragraph (1)(a) and (b) entail that the entirety of the Borrower's debit is disallowed, irrespective of any additional facts, whatever they may be.

7. It follows from this that the para 13 issue falls to be considered by the tribunal only on the basis of the agreed facts, to which we shall refer below, and the facts in (1)(a) and (b). The examples given of possible additional facts are not agreed facts, and no findings are to be made in respect of them. They are described only to illustrate the dispute between the parties: on the one hand HMRC arguing that the application of para 13 can be determined solely by reference to the specified facts; on the other the Borrower arguing that a full factual enquiry of each individual case would be necessary. The question is essentially one of principle only (the parties were not agreed whether it was a question solely of law, but that does not matter); it has been agreed that if we find in favour of the Borrower in this respect, the appeal in that respect may be allowed, and there will be no further consideration of the underlying facts either in the case of the Borrower or the related cases.

The facts

8. The relevant facts can, as we have noted, be simply described. The parties helpfully produced the following statement of agreed facts, which we have adopted, amending it only to refer to the parties by their descriptions:

> 1. The Lender, the Borrower and the Share Recipient are UK resident companies, incorporated in England and Wales. At all material times the Lender was the parent company of the Borrower and the Share Recipient.
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> 2. By an agreement dated 7 April 2003 ("**the Loan Agreement**") between the Lender and the Borrower, the Lender agreed to lend £102,450,000 to the Borrower ("**the Loan**") in the terms set out in the Loan Agreement.
>
> 3. Under the Loan Agreement, the Borrower issued a number of preference shares to the Share Recipient, having a value at issue of £3,528,631. The number and value of the shares were calculated so as to be equal to a market rate of interest on the sum lent for the period of the Loan.
>
> 4. The only reason for the design, structure and terms of the Loan was to obtain a tax advantage for the Lender and/or the Share Recipient (in that the entirety of any payments made by the Borrower would escape tax altogether in the hands of the Lender and/or the Share Recipient).
>
> 5. The Borrower had a commercial need for the borrowing.
>
> 6. The Borrower had no shareholding in the Lender or the Share Recipient.
>
> 7. The Borrower knew at the time of entering into the Loan Agreement that it was designed and structured as mentioned at paragraph 4 above.
>
> 8. The Share Recipient knew at the time the Loan Agreement was entered into that it was designed and structured as mentioned at paragraph 4 above.

> 9. The Fourth Appellant, Prowting Limited, is a UK-resident company, incorporated in England and Wales and at all material times was a member of the Westbury group of companies.
>
> 10. Prowting received preference shares issued by another member of the Westbury group.

9. Leaving aside for the time being the accounting evidence we received, that is the full extent of the facts we are asked to find in relation to the Lender issues (accounting and s 786 ICTA) and the Borrower issue (para 13, Sch 9 FA 1996: unallowable purpose). Mr Prosser invited us to make certain further findings of fact, based on the documents before us, in relation to the Share Recipient issue (Sch D, Case VI). As those findings relate only to that issue, we shall address those points when we deal with the Share Recipient issue.

The Lender issues

10. We turn then to consider the Lender issues. As we have described, there are two questions for us to consider, which have been argued in the alternative. We shall consider later in this section the application of s 786 ICTA. We look first at the accounting issue, namely whether the value of the Shares issued to the Share Recipient forms part of the profits of the Lender under Chapter 2, Part 4 FA 1996 on the ground that the accounts are incorrect in that the correct and only application of GAAP required the Lender to recognise interest income on the Loan.

The accounting issue

11. Many will be familiar with the statutory basis on which this question arises, but we think it may be helpful if we briefly explain the position. The FA 1996 introduced a statutory code for the taxation of loan relationships. Profits and gains, on the one hand, and deficits on the other, are computed using the credits and debits given by the statutory code for the accounting period in question (s 82(1)). Subject to certain detailed provisions, s 84 FA 1996[1] provides that:

> "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

[1] The loan relationships provisions in FA 1996 have been re-written to the Corporation Tax Act 2009. As we are concerned with transactions that took place in 2003, we refer to the provisions of FA 1996 in force at the relevant time.

> the purposes of its loan relationships and related transactions."

The Loan is a loan relationship. The Lender has a creditor relationship, and the Borrower has a debtor relationship.

12. As the credits and debits to be brought into account by the Lender will be the sums which represent interest, charges and expenses and other profits, gains and losses in respect of the Loan in accordance with an authorised accounting method, the question is whether the accounting treatment adopted by the Lender (which did not bring any interest income or other profit into account in respect of the Loan) is authorised. For this purpose it will be authorised only if it is in conformity with generally accepted accounting practice (GAAP): see s 85(2) FA 1996.

13. If the Lender's accounting method is in accordance with GAAP it will be authorised, even if it is not the only, or even the best (or fairest), method that accords with GAAP. Thus, and this was common ground, if HMRC are to succeed on the accounting issue, we must find that the correct and only application of GAAP in the circumstances of the Lender is to require the Lender to recognise interest income (or other profit) on the Loan. If we find that the Lender's accounting treatment was compliant with GAAP at the material time, then the application of the loan relationships rules will follow the treatment in the Lender's accounts, and no loan relationship credit will arise.

Expert accounting evidence

14. To assist us in determining this accounting question we had the benefit of evidence from two expert witnesses. The expert called by the Lender was Philip Barden, a chartered accountant and partner of Deloitte LLP, and the current chairman of the ICAEW Financial Reporting Editorial Board. HMRC called David Henworth, a chartered accountant who has since 2009 been employed by HMRC as an Advisory Accountant in HMRC's Large Business Service Directorate.

15. Both Mr Barden and Mr Henworth were asked questions going to their independence. In Mr Barden's case the issue was that Deloitte had audited two of the lead appellants. Mr Barden made it clear that this had not influenced his views. Likewise, when questioned about his role within HMRC, and whether that had affected the views he had expressed, Mr Henworth was equally clear that it had not. We are satisfied that both experts can be regarded as independent in the views they have expressed, and that there is nothing in their respective positions that would lead us to attribute more or less weight to the evidence they gave us.

16. As well as the experts' individual reports, they helpfully worked together on a joint report which summarises areas of agreement between the experts as well as the areas of disagreement. Both experts gave oral evidence and were cross-examined; they also gave helpful answers to questions raised by the tribunal. Following that evidence, counsel for the appellants and for HMRC each provided us with written submissions on the accountancy evidence, for which we are grateful.

Expert evidence: areas of agreement

17. We take the following areas of agreement from the joint report:

(1) In 2003 there was no UK accounting standard specifically addressing the accounting by a lender. The Lender was therefore required, in devising an appropriate accounting policy, to consider the requirements of FRS 5 (Financial Reporting Standard 5: Reporting the Substance of Transactions).

(2) FRS 5 required the Lender to determine the substance of the lending transaction and to report the substance in its accounts. FRS 5 sets out to determine the substance of a transaction, including how to identify its effect on the assets and liabilities of an entity, and whether any resulting assets and liabilities should be included in the balance sheet.

(3) FRS 5 requires an analysis of the impact of a transaction on an entity. In the majority of cases, the substance identified by the parties in a transaction will be complementary or symmetrical. However, FRS 5 does not require the substance identified by the different parties to be complementary or symmetrical.

(4) In 2003 it was generally accepted accounting practice for a lender and borrower to account for an interest-free loan (typically intra-group) at the amount advanced, without recognising notional interest income, and such a treatment was not in conflict with FRS 5.

FRS 5

18. We set out below material extracts from FRS 5:

> **General**
>
> ***Identification and recognition of the substance of transactions***
>
> **e** A key step in determining the substance of any transaction is to identify whether it has given rise to new assets or liabilities for the entity and whether it has increased or decreased the entity's existing assets or liabilities. Assets are, broadly, rights or other access to future economic benefits controlled by an entity; liabilities are, broadly, an entity's obligations to transfer economic benefits.
>
> **Financial Reporting Standard 5**
>
> ***Definitions***
>
> **2** **Assets**:- Rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.
>
> **3** **Control in the context of an asset**:- The ability to obtain the future economic benefits relating to an asset and to restrict the access of others to those benefits.
>
> …
>
> **5** **Risk**:- Uncertainty as to the amount of benefits. The term includes both potential for gain and exposure to loss.

Statement of standard accounting practice

General

The substance of transactions

14 A reporting entity's financial statements should report the substance of the transactions into which it has entered. In determining the substance of a transaction, all its aspects and implications should be identified and greater weight given to those more likely to have a commercial effect in practice. A group or series of transactions that achieves or is designed to achieve an overall commercial effect should be viewed as a whole.

…

The substance of transactions

Identifying assets and liabilities

16 To determine the substance of a transaction it is necessary to identify whether the transaction has given rise to new assets or liabilities for the reporting entity and whether it has changed the entity's existing assets or liabilities.

…

Assessing commercial effect by considering the position of other parties

51 Whatever the substance of a transaction, it will normally have commercial logic for each of the parties to it. If a transaction appears to lack such logic from the point of view of one or more parties, this may indicate that not all related parts of the transaction have been identified or that the commercial effect of some element of the transaction has been incorrectly assessed.

52 It follows that in assessing the commercial effect of a transaction, it will be important to consider the position of all parties to it, including their apparent expectations and motives for agreeing to its various terms. In particular, where one party to a transaction receives a lender's return but no more (comprising interest on its investment perhaps together with a relatively small fee), this indicates that the substance of the transaction is that of a financing. This is because the party that receives a lender's return is not compensated for assuming any significant exposure to loss other than that associated with the credit worthiness of the other party, nor is the other party compensated for giving up any significant potential for gain.

Identifying assets and liabilities

53 In accounting terms, the substance of a transaction is portrayed through the assets and liabilities, including contingent assets and liabilities, resulting from or altered by the transaction. A key step in reporting the substance of any transaction is therefore to identify its effect on the assets and liabilities of the entity.

Assets – control of access to benefits

> **54** The definition of an asset requires that access to future economic benefits is controlled by the entity. Access to future economic benefits will normally rest on a foundation of legal rights, although legally enforceable rights are not essential to secure access. Control is the means by which the entity ensures that the benefits accrue to itself and not to others. Control can be distinguished from management (ie the ability to direct the use of an item that generates the benefits) and, although the two often go together, this need not be so. For example, the manager of a portfolio of securities does not have control of the securities, as he does have the ability to obtain the economic benefits associated with them. Such control rests with his appointor who has delegated to the manager the right to take day-to-day decisions about the composition of the portfolio.

Areas of disagreement in outline

19. The experts disagree over the substance of the transaction for the Lender and hence over how that substance should have been reflected in the Accounts.

20. Mr Henworth's view is that, for the Lender, the only acceptable view of the substance of the transaction is that the Lender has earned a lender's return on the Loan, which was contributed to the Share Recipient. The commercial effect is that of an interest bearing loan entered into between the Lender and the Borrower. The relationship of parent and subsidiary between the Lender and the Share Recipient explains the commercial logic for the Lender entering into an arrangement where the return on the Loan was received by the Share Recipient, because it meant that the benefit of the Loan was not lost to the Lender on issue of the Shares. The Lender should therefore account for this lender's return. Essentially, Mr Henworth considers the correct treatment to be that in substance the Lender has made an interest-bearing loan to the Borrower and has then made a gift or contribution of that interest (the lender's return) to the Share Recipient.

21. Mr Barden considers that an accurate description of the substance of the transaction from the perspective of the Lender is that it has made the Loan in exchange for the right to receive back the principal advanced and the right to insist on a transfer of value between its wholly-owned subsidiaries. Because the right to insist on a transfer of value between its wholly-owned subsidiaries has no incremental value for the Lender and would be valueless to a third party, it is not logical to assign any value to it for the purposes of FRS 5. Accordingly, the economic benefit of the transaction for the Lender is the same as if the Lender had made an interest-free Loan to the Borrower.

Mr Barden's view

22. We start with Mr Barden as, if we are satisfied that his approach to the accounting by the Lender in respect of the Loan is within what is permitted under FRS 5, that will determine this element of the appeals. We will examine the approach taken by Mr Henworth to see if, as HMRC claim, that approach is the only one that

would be possible under FRS 5 and so be GAAP compliant, as well as the criticisms made by Mr Henworth of the approach adopted by Mr Barden.

23. Mr Barden takes as his starting point the legal form of the transaction, which is that the Shares are not received by the Lender, nor does the Lender have rights to receive the Shares. He then considers, in accordance with para 16 of FRS 5, whether the transaction has given rise to new assets or liabilities for the Lender (the reporting entity) and whether it has changed the Lender's existing assets and liabilities.

24. Mr Barden placed emphasis on this step in his analysis. He referred to para 16 of FRS 5 as being "the bedrock on which FRS 5 is created". Referring to para 52, which states that it is important to consider the position of all the parties to a transaction, Mr Barden's view is that this does not override the requirement of para 16 to determine the substance of the transaction by focusing on the effects on the reporting entity's assets and liabilities. He says that in effect para 52 ensures that all pertinent facts are considered in making the analysis, but para 16 imposes a strict discipline that the analysis must be based on changes to assets and liabilities.

25. Adopting that approach to FRS 5, Mr Barden concludes that the only additional rights arising for the Lender as a result of the transaction are the right to receive back the principal loaned and the right to insist that the Shares are issued by the Borrower to the Share Recipient. In Mr Barden's view, it cannot be assumed that the value of the Lender's right to insist on a transfer of shares between its subsidiaries is the same as the value of a right to receive those shares; they are not the same thing. He goes on to conclude that the right of the Lender to insist that the Shares are issued to the Share Recipient is not a valuable asset of the Lender in its own right; it can have value only in so far as it increases the value of the Lender's investment in the Share Recipient.

26. On the question of value, Mr Barden looks both at the value to a third party of the right to require that the Shares are issued to the Share Recipient, and whether the Lender would itself be worse off if it ceased to have that right. He concludes that an unrelated third party would pay nothing for such a right as it would be unable to extract any value from it, and that the Lender would not be worse off by ceasing to have that right, as the obtaining of such a right would not add anything to the Lender's ability to effect transfers of assets between subsidiaries, and so could have no incremental value to the Lender.

27. Mr Barden recognises that the Lender's right to insist that the Shares are issued to the Share Recipient increases the value of its investment in the Share Recipient. That is a change to an existing asset of the Lender and, in accordance with para 16 of FRS 5, consideration needs to be given to whether that change should be reflected by the Lender in its financial statements. In this respect, Mr Barden takes the view that, because the Shares are issued by the Borrower, another wholly-owned subsidiary of the Lender, the increase in the value of the Lender's investment in the Share Recipient is matched by an equal decrease in the value of its investment in the Borrower. Thus, reasons Mr Barden, the Lender should be economically indifferent to whether or not the transfer of shares takes place. Although the Lender has obtained the right to insist on a transfer of value between two wholly-owned subsidiaries, the Lender is not better

off overall as a result of receiving that right, nor is it economically affected by whether or not it chooses to exercise that right.

28. Mr Barden notes that it is reasonably common for value to be transferred between subsidiaries without the parent recognising a gain. He refers to the common example of businesses being sold between two UK subsidiaries at book value rather than fair value. For the parent of those subsidiaries, this has the consequence of making the selling subsidiary less valuable and the buying subsidiary more valuable. Mr Barden considers that no gain is typically recognised in the parent as a result of such a transaction; such a transfer would at most trigger a need for the parent to reallocate part of its costs of investment in the selling subsidiary to its costs of investment in the buying subsidiary, but that would not involve the parent recognising a gain.

29. Mr Barden accordingly concludes that an accurate description of the substance of the transaction from the perspective of the Lender is that it has made the Loan in exchange for the right to receive back the principal advanced and the right to insist on a transfer of value between its wholly-owned subsidiaries. Judged by reference to what a third party might pay for the right, and whether anything is added to the existing ability of the Lender to procure a transfer of value between its subsidiaries, the Borrower and the Share Recipient, that right has no incremental value to the Lender, so that no value should be assigned to it for the purposes of FRS 5. As Mr Barden explained in his evidence to us, the question is not one of value in itself, but whether the right is separate from existing rights of the Lender that are already embodied in the investment, which are existing assets. Accordingly, in Mr Barden's view, the economic substance of the transaction for the Lender is the same as if it had made an interest-free loan. Nor does the fact that the Borrower is likely to regard the substance of the transaction as the making to it of an interest-bearing loan alter that analysis; whilst FRS 5 requires consideration to be given to the whole transaction, para 16 focuses on the assets and liabilities of the individual reporting entity, and does not require symmetry.

30. Mr Barden then considers whether this analysis of the substance of the transaction from the perspective of the Lender has commercial logic for all parties to the transaction, according to paras 51 and 52 of FRS 5. He concludes that, given the parent-subsidiary relationship, an interest-free loan would not lack commercial logic. Nor does the fact that a benefit is received by another subsidiary alter that commercial logic, or affect the substance of the transaction for the Lender.

Mr Henworth's view

31. Mr Henworth takes the view that the approach set out in FRS 5, and accounting commentary on FRS 5, requires the arrangement to be analysed and the commercial effect to be understood before the impact on the entity's assets can be determined. His starting point therefore is paras 51 and 52 of FRS 5, which explain how to assess the commercial effect by considering the position of other parties. He reasons that, in analysing the substance of the transaction, those paragraphs would logically be applied before para 16 of FRS 5.

32. Mr Henworth places considerable weight on para 52 of FRS 5, where it deals with the case where a party receives only a lender's return. He considers that the guidance given by para 52 is helpful in considering the commercial effect of the transaction. He concludes that, viewing the transactions forming the arrangement as a whole, as required by para 14 of FRS 5, the Loan between the Lender and the Borrower was an interest bearing loan and the Accounts should reflect a transaction with that substance.

33. In Mr Henworth's view, in group situations there is commercial logic for entering into conventional interest-free loans, and in those circumstances neither the lender nor the borrower would recognise any amounts in respect of interest. In this way the accounts of a lender and borrower would report the substance of an interest-free arrangement; it is not interest bearing and no interest is recognised. There is, on the other hand, also commercial logic for entering into conventional interest-bearing loans, and in those circumstances the borrower would recognise the cost of finance and the lender would recognise its lender's return.

34. Mr Henworth takes the view that, without having regard to the position of the other parties (which, Mr Henworth notes, para 52 of FRS 5 says it is important to consider), the entering into a loan which pays a commercial rate of interest but on which a lender does not receive a lender's return lacks commercial logic. On considering why the Lender entered into the Loan arrangement, and the position of the Share Recipient, the commercial logic becomes apparent. The relationship between the Lender and the Share Recipient, namely that of parent and wholly-owned subsidiary, means that the benefit of the lender's return earned during the term of the Loan is not lost to the Lender on issue of the Shares to the Share Recipient.

35. Mr Henworth's analysis therefore is that the transaction results in substance in the Lender having a new asset, namely the lender's return on the Loan, which should be accounted for as a gain in the Lender's Accounts. The overall commercial effect of the series of transactions is that the lender's return on the Loan has been earned by the Lender and contributed by the Lender to the Share Recipient. The lender's return is to be recognised in the Accounts of the Lender. On issue of the shares, the effect is that the lender's return asset should be derecognised and a new asset, an additional cost of investment in the Share Recipient, recognised. The effect is no different from that if the Lender had first received the Shares at the end of the term of the Loan and had then contributed them to the Share Recipient.

Criticism of Mr Barden's analysis

36. Mr Henworth criticises the approach taken by Mr Barden in forming his view as to the nature of the additional rights arising to the Lender from the transaction, namely the repayment of principal and the right to require the issue of the Shares by the Borrower to the Share Recipient. Mr Henworth says that this treats the different transactions separately as, first, a loan, and secondly as a transfer of value between subsidiaries. This, Mr Henworth says, fails to recognise the relationship between the Shares and the Loan, namely that the total value of the Shares to be issued increases over the term of the Loan and is linked directly to the market cost of the borrowing.

As a consequence, it is said, the overall commercial effect of the series of transactions, that the lender's return has been invested in a subsidiary, is not identified by Mr Barden.

37. Mr Henworth considers that in Mr Barden's analysis of the economic effect of the issue of the Shares by Borrower to Share Recipient, the identification of commercial logic appears only to reflect the arrangement from the position of the Lender rather than, as noted in FRS 5, the position of the other parties. In particular, says Mr Henworth, the analysis does not appear to consider whether it is the position of the Borrower as a borrower, rather than as a subsidiary, that impacts the commercial effect of the transaction.

38. Mr Henworth's view is that, during the term of the Loan, the lender's return provides future economic benefit to the Lender because it is the economic means of making additional investment in the Share Recipient, in the same way as it would provide future economic benefit if it was applied in settling a liability through the same Share issue mechanism. Furthermore, in Mr Henworth's opinion, the Lender has not only the right to future economic benefit but also control over that right, since it is the only party that can require the issue of the Shares. It therefore has an asset during the term of the Loan which increases in value with the gain being the interest or finance income earned on the Loan. Accordingly, Mr Henworth does not agree with Mr Barden that the future issue of Shares whose value accrues during the term of the Loan was of no value to the Lender.

39. Mr Henworth considers that, because he and Mr Barden have assessed the commercial effect of the transactions differently, the assets that each considers are not the same. Mr Henworth identifies the right to future economic benefit as being the return on the Loan with the ability to require the Shares to be issued being an aspect of control over that right. He also refers, by reference to para 17 of FRS 5, to the risks inherent in the benefits associated with the asset as supporting his view that the Lender had an asset in the form of the lender's return over the term of the Loan. This, he explains, is because the Lender was exposed to the credit and prepayment risks just as a lender would be in the case of a plain vanilla loan, and such risks could impact the value of the return which was contributed to the Share Recipient. By contrast, Mr Barden considers whether the right to require the shares to be issued is instead an asset. This difference in approach is reflected in the different views expressed

40. In that context, Mr Henworth disagrees with Mr Barden's view that, because the increasing value of the Shares to be issued over the term of the Loan has no value to a third party, no value should be assigned to it for the purposes of FRS 5. Mr Henworth compares this to the position of a prepayment to a supplier, arguing that even though the value of the goods or services in respect of which the prepayment is made may have no value to a third party, this would not preclude the prepayment from being recognised on the balance sheet of the purchaser at cost. Equally, says Mr Henworth, the increasing value of the lender's return represented by the Shares to be issued has value to the Lender in that the return was applied in providing a valuable contribution to the Share Recipient even if, as with a prepayment, that use has been pre-determined.

41. Mr Henworth disagrees with Mr Barden's view that, so far as the Lender is concerned, the issue of the Shares by the Borrower to the Share Recipient is economically neutral (that is, the issue of the Shares transfers value without resulting in an overall increase in value) and that this should impact the accounting in the Lender. He gives the following reasons:

(a) The Lender accounts for its investments under the historic costs accounting principles. Therefore the additional cost of investment in the Share Recipient would not be matched by an impairment in the carrying value of the Borrower in the financial statements of the Lender simply because the Shares had been issued by the Borrower to the Share Recipient. In the accounts of the Borrower, its underlying assets would be no different before or after the transaction. The interest liability that accrued during the term of the Loan would be offset by the Shares issued at the end of the term. Consequently, at the end of the Loan, the Lender's investment in the Borrower would not be impaired as a result of the issue of the Shares.

(b) The circumstances of this transaction are different from those of a hive-across reorganisation, shifting value from one subsidiary to another. The arrangement under review involves an interest-bearing loan and the payment of interest, which need to be considered in determining the substance of the transaction.

(c) If, for example, a parent receives interest in the form of case on a loan made to a subsidiary, the parent/lender would be economically no better off. The value of the subsidiary would have fallen by the extent of the interest paid to the parent, but this would have been offset by the value of the interest received by the parent. UK GAAP would, however, require the parent/lender to recognise the interest income. In that scenario, the impact of the transaction is that the parent has a new asset, being the interest received, namely the cash. Even though the lender is economically no better off, the lender's return is recognised because this reflects the substance of the transaction, namely that the parent/lender has a gain and a new asset. Similarly, in the transactions under review, at the end of the series of transactions, the Lender has a new asset being an additional investment in the Share Recipient resulting from the return on the Loan.

(d) Neutrality does not reflect the different assets of the Lender before and after the Shares are issued. During the term of the Loan the asset and gain which accrues to the Lender has the characteristics (both benefits and risks) of a lender's return. Once the Shares have been issued and the principal repaid, the Lender no longer holds a lender's asset. It has a new additional cost of investment in the Share Recipient, in other words a new asset. The cost of that investment is the value of the lender's return earned during the term of the Loan with the associated Lender's asset being derecognised at the end of the Loan and the investment asset being recognised instead.

Discussion of expert evidence

42. It will be apparent that the experts have adopted very different approaches to the application of FRS 5 to the determination of the substance of the transactions in this case, and the consequent accounting treatment of the Lender. The question for us, in essence, is whether the approach of Mr Barden is an acceptable one, such that the treatment actually adopted by the lender is within GAAP, and is thereby an authorised accounting method within s 85(2) FA 1996.

43. In our view Mr Barden's approach is one that is acceptable for the purposes of FRS 5, and we therefore conclude that the Lender's accounting method is authorised, and that the Lender's credits and debits on its loan relationship should be determined without reflecting any gain in respect of the Shares issued by the Borrower to the Share Recipient. We explain our reasons for reaching that conclusion below.

44. It is the different approach adopted by the respective experts that, in our view, has led to Mr Barden and Mr Henworth coming to opposing views on the asset to which the transaction has given rise for the Lender as a result of the transactions. But in addition they disagree as to the commercial logic of the transactions.

45. Mr Barden's approach is to begin by ascertaining whether the Lender has a new asset, or whether there has been any change to the existing assets of the Lender. He does this before considering the commercial logic of the transactions, but having regard to the transactions as a whole and their commercial effect. This, in our view, is the correct approach to be adopted having regard to paras 14 and 16 of FRS 5; in particular it follows the terms of para 16, which emphasises the need to identify the asset in order to determine the substance of the transaction. The substance of the transaction thus follows from the identification of the assets; the identification of the assets does not flow from a view taken on the substance of the transaction.

46. What Mr Barden is doing therefore is examining the component parts of the transaction from the perspective of the Lender (the reporting entity, whose assets are the focus of the enquiry under para 16). On this basis, he rejects the notion that the Lender has an asset in the form of the lender's return represented by the Shares. The only additional rights of the Lender as a result of the transaction are the right to repayment of the principal of the Loan and the right to insist that the shares are issued by the Borrower to the Share Recipient. Then, because Mr Barden takes the view that such a right has no incremental value to the Lender, Mr Barden concludes that this right is not a new asset of the Lender. The only new asset is the right to repayment of the Loan, so that the economic substance of the transaction for the Lender is that of an interest-free loan.

47. It is at that stage that Mr Barden considers the commercial logic of that analysis, concluding that the transaction entered into by the Lender is analogous to an interest-free loan within a group. The fact that the benefit in this transaction is not retained by the subsidiary which borrows the funds, but passes to another subsidiary, does not alter the commercial logic within a group.

48. By contrast with the approach of Mr Barden, Mr Henworth starts by considering the commercial logic and the commercial effect, applying paras 51 and 52 of FRS 2. By this approach he notes, first of all, that the Loan from the Lender to the Borrower is interest-bearing, as it carries a lender's return in the form of the issue of the Shares. However, a feature of that Loan is that the Lender does not receive the Shares. Mr Henworth examines the commercial logic for that, and finds it in the fact that the Share Recipient will receive the Shares. This, reasons Mr Henworth, means that the Lender has not lost the benefit of the lender's return, as the commercial effect is that the lender's return has been contributed to the Share Recipient.

49. On this basis, Mr Henworth reasons, before applying para 16 of FRS 5, that the transaction as a whole looks like an interest-bearing loan at a commercial rate of interest, with the interest not being received directly by the lender but being invested by the lender. Mr Henworth then concludes, as the second stage in his process, that the lender's return (namely the Shares) is an asset of the Lender which must be recognised in the Lender's accounts over the term of the Loan, being derecognised and replaced by the new asset of an additional cost of investment in the Share Recipient on the issue of the shares to the Share Recipient. Mr Henworth confirms his analysis by reference to the economic benefit that he regards the Lender as having because the lender's return is the economic means by which the additional investment in the Share Recipient is made, the control he finds that the Lender has by virtue of its right to require the issue of the Shares, and the risks that could impact the value of the return contributed to the Share Recipient.

50. We consider that the approach of Mr Barden corresponds more exactly with the approach expected under FRS 5 that that of Mr Henworth. We believe that Mr Henworth's approach fails to recognise that under FRS 5 it is essentially the identification of the new or enhanced assets that determines the substance of the transactions. Mr Henworth's approach is to determine the substance of the transactions by reference to their commercial effect or commercial logic, and to seek to identify from that analysis the new asset or assets of the reporting entity. We do not therefore consider that Mr Henworth's analysis can be the only acceptable view under FRS 5 or GAAP; still less that Mr Barden's view can be said to be incompatible with those standards.

51. Mr Henworth's approach starts with a re-analysis of the transaction, employing commercial logic and commercial effect, in order to conclude, on the basis of that re-analysis, that the Lender is to be regarded as having received the lender's return, in the form of the Shares, and as having made a capital contribution of those Shares to the Share Recipient. This re-analysis leads to Mr Henworth finding that the Lender has a new asset (the Shares) as a lender's return. Although we accept that the Shares are a real asset, and that Mr Henworth is not seeking to account for a hypothetical asset, his re-analysis of the transaction does give rise to hypothetical steps, namely the receipt (or entitlement to receipt) by the Lender of the lender's return and the contribution of it to the Share Recipient.

52. Mr Barden's approach, of looking for a new asset of the Lender by reference to the actual transaction, and testing what he finds in that respect by reference to

commercial logic for all parties, is in our view more consistent with the terms of FRS 5 than is Mr Henworth's approach. We accept Mr Ghosh's submission that we should not read FRS 5 as if it were a statute, and to that end we also accept that different approaches might be possible within the broad ambit of FRS 5, but we do not consider that we should ignore the careful and thorough way in which the guidance in FRS 5 has been expressed.

53. In their written submissions on the accounting evidence Mr Ghosh and Ms Wilson submitted that Mr Barden was wrong to conclude that the treatment of the Loan transaction as an interest-free loan made by the Lender to the Borrower was a proper accounting treatment. They argued that such an analysis was inconsistent with commercial logic because it does not answer the question why the Lender agrees that the Shares are issued to the Share Recipient and not to it (albeit that the Share issue is enforceable by the Lender). In our view Mr Barden's view of the commercial logic is clear, and it cannot be said that his analysis is inconsistent with it. The simple reason for the Lender having only a right to the return of principal and not to the issue of the Shares, representing a return on the principal amount, which pass to the Share Recipient is that the Share Recipient is the wholly-owned subsidiary of the Lender. That provides commercial logic for the analysis.

54. Although Mr Henworth suggested that this analysis looked at the separate transactions and not to the commercial effect, we do not agree. The commercial effect was a financing of the Borrower and an increase in the value of the Lender's investment in the Share Recipient. Those effects were taken into account in Mr Barden's analysis. Mr Henworth in our view was not simply looking at the commercial effect; he was working backwards from the commercial effect of a transaction to establish a different way of achieving the same commercial effect, but with different steps – in this case the receipt by the Lender of a lender's return and its subsequent contribution to the Share Recipient - with the result that the Lender could be regarded as having an asset that, although it existed, was never an asset of the Lender. Although Mr Henworth's analysis was that the commercial effect of the transaction was to enable the Lender to invest in the Share Recipient, that is in our view not a commercial effect, but a re-analysis of the steps that might achieve the commercial effect.

55. There was considerable argument over whether the Lender had obtained no value in its capacity as Lender from the transaction. As will be recalled, Mr Barden's analysis was that, although there was an increase in the value of the Lender's investment in the Share Recipient, that increase in value would be matched by an equal decrease in the value of its investment in the Borrower. Mr Henworth disagreed with that analysis, pointing to the effect of the issue of the Shares in the Borrower's accounts.

56. On the question of value, we accept that the accounting in the Borrower at the stage of the Share issue would, at the material time, have given rise to the extinguishment of the liability accrued by the Borrower for the cost of the Loan, and its replacement by the Shares in shareholder's funds. At the material time that would have extinguished the liability, but not replaced it with another liability. There would

therefore have been an increase in the net asset value of the Borrower. Part of that increase would be attributable to the new Shares, and there would be no reduction in the value of the Lender's investment in the Borrower. On the other hand, the value of the Lender's investment in the Share Recipient would be increased by means of the Shares having been acquired by the Share Recipient.

57. Mr Ghosh and Ms Wilson accept that it is correct to say, as was noted by the tribunal at the hearing, that the Lender would not be better off if consideration is given to the position before the transaction. This is because the creation of the liability for the accruing obligation to issue the Shares diminishes the value of the Borrower during the term of the Loan, and the extinguishment of that liability on the issue of the Shares merely restores the pre-Loan value of the Borrower. The dilution of the Lender's shareholding in the Borrower does then reduce the value of the Lender's investment in the Borrower to the same extent as the value of its investment in the Share Recipient is increased. Mr Ghosh and Ms Wilson argue, however, that this is not relevant because it is the application of FRS 5 to the Loan which is under scrutiny.

58. We do not accept that argument. FRS 5 is directed at the Loan, but the accrual of the liability in the Borrower is an incident of the Loan, and therefore falls to be taken into account in considering the commercial effect of the transaction, all components of which must be considered in the FRS 5 analysis. The value of the Lender's increased investment in the Share Recipient cannot be viewed in isolation from the reduction in the value of the Borrower by reason of its accrual of the liability under the Loan. FRS 5 requires all aspects and implications of a transaction or series of transactions, viewed as a whole, to be identified. These aspects are not without commercial effect, and so must be given weight.

59. Furthermore, in analysing the effect of the increase in the value of the Lender's investment in the Share Recipient, we consider that Mr Barden was right to consider the substantive effect on the group as a whole; FRS 5 is looking to substance to determine the correct accounting treatment of a particular company, and not to the accounting treatment of individual companies to determine substance. Looked at from the perspective of the group as a whole, the substantive analysis is that no new asset was created for the group, and there was no increase in the collective group's assets, or accordingly in the overall assets of the Lender as parent company of that group.

60. For all those reasons, we conclude that Mr Barden was entitled to conclude that the increase in the value of the Lender's investment in the Share Recipient was matched by an equal decrease in the value of its investment in the Borrower, that the Lender was not better off overall as a result of receiving the right to insist on a transfer of value between the Borrower and the Share Recipient and the lender was not economically affected by whether or not it chose to exercise that right.

61. Having said that, we also consider that, even if the correct approach would be to have regard only to the accounting effect of the effective capitalisation of the liability in the Lender, that would not inevitably, or even likely, result in the sort of re-analysis

of the transaction undertaken by Mr Henworth. On such a basis it might be said that the Lender has obtained an enhancement of the value of its investment in its subsidiary, the Share Recipient, without a concomitant reduction in the value of its investment in the Borrower. But we do not consider that this would necessarily lead, as it does in Mr Henworth's opinion, to the Lender being regarded as having a new asset in the form of the lender's return, or the Shares themselves.

62. Mr Ghosh and Ms Wilson also criticised the economic neutrality analysis of Mr Barden by pointing to the fact that, if the Lender had suffered a reduction in the value of its investment in the Borrower, that would not be reflected as an accounting loss in the Lender, because the Lender had prepared its accounts under the historic cost convention. According to the Lender's accounting policies, "investments held as fixed assets are stated at cost less any provision for any impairment in value". No such diminution in value was reported in the Accounts. In our view, the application of the historic cost convention has no relevance to the ascertainment of the substance of a transaction. The substance must be ascertained by reference to the commercial effect of the transaction, and in particular by reference to new assets and liabilities, or enhancements or diminutions in value of existing assets. The accounting treatment, including whether such value increases or reductions would be reflected in the cost of investment in the financial statements, is not relevant to that analysis. It is only once the effect on assets and liabilities in substance has been ascertained that the accounting treatment of those assets and liabilities falls to be considered.

63. It is inevitable that expert evidence will refer to other transactions by way of analogy in seeking to support conclusions that are reached. This case was no exception. We have, however, found such comparisons of little assistance. Those comparisons might assist in determining the accounting treatment of the transaction once its substance and the new assets and liabilities have been determined in accordance with FRS 5, but they are in our view of little assistance in reaching a conclusion on the question of the substance itself. The difference between Mr Barden and Mr Henworth is on the question of substance. Comparisons between this transaction and a hive-across of assets between subsidiaries, whilst relevant to the accounting treatment of the substance of the transaction as it is analysed by Mr Barden, do not assist in arriving at the analysis of that substance. Nor did we consider that Mr Henworth's reference to a prepayment being recognised in a purchaser's balance sheet assisted in analysing the value to the Lender of the right to insist that the Shares be issued to the Share Recipient; that again was looking at the accounting treatment of an asset and not the ascertainment of the asset itself.

64. For the same reason, we were not assisted by references to the accounting treatment of an interest-bearing loan between parent and subsidiary, where the interest is paid to the parent. It was accepted that in such a case the parent would book a profit on the interest received, even though in that case the parent would suffer a reduction in the value of its investment in the subsidiary equal to the interest paid. That example is relevant only to a case where the substance of the transaction is to be analysed as being that of such a receipt of interest.

65. Mr Ghosh and Ms Wilson argued that there was no material difference between such a receipt of interest on an interest-bearing loan and this transaction. They challenged Mr Barden's evidence that the right to require the Borrower to issue the shares to the Share Recipient was not a new asset of the Lender because the Lender, as the parent company of the Borrower, already had the right to require a transfer of value between its subsidiaries. They argued that the issue of the Shares allowed the Lender to obtain an asset which constituted a benefit to the Lender by enabling it to invest in the Share Recipient. That, they submitted, is just as valuable as a receipt of cash on an interest bearing loan owed by a subsidiary to its parent, because otherwise the Lender would have had to find an equal amount to invest from its own resources, an asset other than interest due from the Borrower on the Loan made by the Lender.

66. We do not accept that an argument that relies on equivalent value to the receipt of interest on an interest bearing loan can determine the substance of a transaction that does not involve such an interest receipt. Value can be obtained by a company in many different ways, and the mere fact that the value of something done by a company is equivalent to the value it could obtain if it had carried out a different transaction, or achieved an equivalent end result in a different way does not mean that the accounting treatment must in all respects be the same. In any event, the argument does not in our view support an analysis that the Lender had a new asset in the form of the lender's return; it offers more support, in our view, to the conclusion that the Lender's only new entitlement (apart from the right to be repaid the principal amount of the Loan) was its right to increase the value of its investment in the Share Recipient.

67. What the expert evidence has shown is that there is scope for accountants to disagree on the result of an application of FRS 5 to a given set of circumstances. For the reasons we have given, we do not consider that Mr Barden's analysis, and consequently that the way in which the Lender reported its profits in the accounts, was outside what was permitted by the application of FRS 5. It is not necessary for us to make any finding as to Mr Henworth's analysis, except to say that we find that the accounting treatment he has concluded would be appropriate is not the only proper accounting treatment within GAAP.

68. We should say, nevertheless, that if a choice between the conclusions reached by the experts had been required, we would have preferred the conclusions reached by Mr Barden over those of Mr Henworth. We have referred earlier to our view that Mr Barden's approach more closely followed the guidance in FRS 5. We were also unconvinced by Mr Henworth's analysis of the new asset being the lender's return, by which, although Mr Henworth's evidence on this was not clear, we take to mean the Shares, as that was the only recognisable asset on Mr Henworth's analysis. We found equally unconvincing Mr Henworth's reliance on an analysis of the control of the Lender over the benefits of the lender's return. According to paras 3 and 54 of FRS 5, control by an entity is related to the means by which that entity ensures that future economic benefits from an asset accrue to that entity and not to others. This transaction in our view is properly analysed as enabling the Lender to ensure the opposite, namely that the economic benefits accrue to its subsidiary; the Lender has no right, unless it takes additional steps, to control that the economic benefit of the

Shares accrues to it. The most that can be said is that the Lender can obtain an indirect benefit by increasing the value of the Share Recipient. That does not, it seems to us, support a conclusion that the Shares themselves, or any other lender's return, should be regarded, on an application of FRS 5, as a new asset of the Lender.

69. Nor did we find Mr Henworth's reference to the risks to which he regarded the Lender as being exposed as convincingly explaining his conclusion that the Lender had an asset in the form of a lender's return. Mr Henworth's view was that the Lender was exposed to the same credit and repayment risks as a lender would be to a plain vanilla loan, and that such risks could impact the value of the return which was contributed to the Share Recipient. Apart from the fact that this risk analysis is on the basis of a conclusion as to the existence of a new asset of the Lender already reached by Mr Henworth, and not for the purpose of ascertaining whether the Lender had such an asset, it seems to us that, so far as the Lender is concerned, these risks are more properly analysed as risks not related to the Shares, but to the potential increase in value of the Lender's investment in the Share Recipient, which accords more with Mr Barden's analysis than it does with that of Mr Henworth.

70. Accordingly we conclude on this issue, in favour of the Lender, that it is not the correct and only application of GAAP to require the Lender to recognise interest income on the Loan, that the Accounts are not incorrect, and that the value of the Shares issued to the Share Recipient does not form part of the profits of the Lender under Chapter 2 of Part 4 to the Finance Act 1996.

Section 786 ICTA

71. We turn next to the second of the issues concerning the Lender, which is whether a tax charge can arise to the Lender under s 786 ICTA. This issue itself has two strands: the first concerns the construction of s 786 itself, and the second is whether s 786 is in any event precluded from having any application by virtue of s 80(1) and (5) FA 1996.

Construction of s 786

72. The relevant parts of s 786 ICTA are as follows:

> "**Transactions associated with loans or credit**
>
> (1) This section applies as respects any transaction effected with reference to the lending of money or the giving of credit, or the varying of the terms on which money is lent or credit is given, or which is effected with a view to enabling or facilitating any such arrangement concerning the lending of money or the giving of credit.
>
> (2) Subsection (1) above has effect whether the transaction is effected between the lender or creditor and the borrower or debtor, or between either of them and a person connected with the other or between a person connected with one and a person connected with the other.
>
> …

> (5) If under the transaction a person assigns, surrenders or otherwise agrees to waive or forgo income arising from any property (without a sale or transfer of the property) then, without prejudice to the liability of any other person, he shall be chargeable to tax under Case VI of Schedule D on a sum equal to the amount of income assigned, surrendered, waived or forgone."

73. HMRC say that, according to its ordinary meaning, s 786(5) renders the income under the Loan assessable on the Lender under Case VI of Schedule D. The reasoning may be summarised as follows:

(1) Under the loan relationship between the Lender and the Borrower, the Borrower issues the Shares to the Share Recipient.

(2) The transactions are with reference to the lending of money or the giving of credit, so fall within s 786(1).

(3) The transactions are between connected persons, so fall within s 786(2) by reference to the definition of connected persons in s 839 ICTA.

(4) The Shares represent income arising from the loan relationship for the purposes of s 786(5).

(5) As the Lender is the creditor of the Loan, it follows that the Shares represent income arising on the Lender's property for the purposes of s 786(5).

(6) As a Lender, in any ordinary course of conduct, will have the right to income arising from its lending of money, a direction (which is enforceable) for that income to be paid to a third party (rather than the Lender) represents a "waiver" or "forgoing" of that income by the Lender for the purposes of s 786(5).

(7) Therefore, by virtue of s 786(5), the Lender in this case is chargeable to tax under Case VI of Schedule D on a sum equal to the value of the Shares issued to the Share Recipient.

74. Mr Prosser and Mr Henderson raise a number of arguments against this analysis. They point to the original purpose of this provision, arguing that it was intended to deal with cases of income tax avoidance and not transactions such as that of the Lender in this case. It is of course necessary for us to construe the legislation purposively, and we shall consider that aspect of the Lender's case shortly. But we first look at the arguments of Mr Prosser and Mr Henderson on the terms of s 786(5) itself.

75. In argument before us, Mr Prosser accepted that on a purely literal reading it is possible to give s 786 an extremely wide application. There is no requirement for any tax avoidance purpose or, we would add, any tax benefit or advantage. There is no requirement that the taxpayer should have received any consideration. Nor is there any escape for commercial transactions.

76. Mr Prosser's argument before us centred upon what is meant by "income arising from any property" in s 786(5). This also featured in the skeleton argument of Mr Prosser and Mr Henderson, where it was submitted that the requirement for "income

arising" was not met in this case because the Lender at no stage had any right to income from the Loan. It was argued that it is not sufficient to say that income would have arisen to the Lender if the Loan had been on ordinary commercial terms, or if the Lender had contracted for it.

77. This argument was described by Mr Prosser in oral argument as an additional argument, but it was elaborated no further. We do not consider that it can assist the Lender. It is clear that s 786(5) is looking to cases where the transaction is such that no income will arise to the relevant person: the reference to assignments and surrenders may refer to cases where an existing right to income is removed from a person, but the further references to waivers and, in particular, to the forgoing of income are arguably wide enough to apply to cases where no right to income arises at all. In this case the Loan carried the right to the Share issue, and there was therefore income arising which is capable of being forgone.

78. For the same reason, although it too was raised in the skeleton argument of Mr Prosser and Mr Henderson, we do not accept that the requirement, under s 786(5), for there to be an agreement on the part of the relevant person to waive or forgo income, can fail to be satisfied in this case. The agreement of the Lender in respect of the Shares, namely that they should be issued to the Share Recipient (and accordingly would not be issued to the Lender) was contained in the loan agreement. The Lender therefore agreed to forgo that income.

79. The burden of Mr Prosser's submissions before us concerned what was meant by "property" in the phrase "income arising from any property". He accepted that, on one interpretation, that would be wide enough to cover the rights of the creditor under the Loan; the Loan constituted property. But, referring to the purpose of s 786(5), Mr Prosser argued that that would not be the correct interpretation. To illustrate the purpose he took us to a published note of the Institute of Chartered Accountants in England and Wales (ICAEW) dated 8 October 1993, published in Simon's Tax Intelligence (1993; issue 42 p 1333-4). In that note the Inland Revenue confirmed that s 786(5) had been introduced to tackle schemes of income tax avoidance. By reference to the legislative history, and the introduction of what became s 786 in the Finance Act 1969 (FA 1969, Sch 13, para 12), Mr Prosser argued that s 786(5) ought properly to be construed so that the "property" in question does not include the loan itself.

80. The schemes of income tax avoidance, Mr Prosser submitted, were of a nature designed to circumvent the introduction, in 1969, of provisions designed to restrict the availability of relief for interest paid to certain specific cases. He argued that the provisions of s 786 could all be explained as counteracting arrangements to enable equivalent relief to be obtained, without relying on the payment of interest as the means for obtaining the relief.

81. Thus, what became s 786(3) could be explained in terms of preventing interest simply being replaced by an annuity or other annual payment. The former s 786(4) (which had been repealed with effect from 6 November 1996) prevented an interest payment effectively being replaced by income from property transferred by the owner

to another party accompanied by an agreement or option for the return of the property to the original owner (a "repurchase", or "repo" transaction). This then explained s 786(5) which, without any sale or transfer of property, applied where instead the income was merely assigned, surrendered or otherwise agreed to be waived or forgone.

82. We accept that it was against the background of the 1969 changes to interest relief that the precursor to s 786 had been enacted. We accept too that s 786 has the effects to prevent circumvention of those provisions as suggested by Mr Prosser. But we do not accept that this evident mischief to which the provisions appear to have been aimed can delineate the scope of s786. Nor do we consider that statements made by the Revenue on its practice in relation to the application of s 786 can have any relevance. It remains necessary to construe that provision according to its terms.

83. The approach taken by Mr Ghosh was very simple. He argued that, according to its terms, s 786 was an anti-avoidance section of wide application. There was no justification for doing anything but apply its clear wording. When that was done it was clear, first, that the transaction undertaken by the Lender was a transaction effected with reference to the lending of money, that the Loan, or the loan agreement, was property on which income arose and that by the provision in the loan agreement that the Shares should be issued to the Share Recipient, that income had been forgone by the Lender.

84. Mr Prosser accepted that, on one interpretation, s 786 could be given a wide meaning. That included s 786(1) which establishes the scope of the section in that it applies "as respects any transaction effected with reference to the lending of money or the giving of credit", and the variation of terms of lending or credit or assisting and arrangement for either of those things. Mr Prosser argued, however, that the way in which that provision was framed supported his argument that the section was dealing with something other than the loan itself, and that accordingly the reference to property in s 786(5) is to something other than the Loan itself.

85. Taken on its own, s 786(5) is of wide import, covering anything that results in income that would otherwise be receivable by a person not being received being subject to a charge to tax. As we have described, we do not consider that the mischief at which the provision might have been aimed can delineate its scope. However, its scope is delineated by s 786(1), which describes the transactions that can fall into the operative provisions of the section, including s 786(5).

86. In our view, the use by the draftsman, in s 786(1), of the term "with reference to" is apt to describe the position where the transaction to which s 786 is to apply as something separate from the lending of money or the giving of credit, or the other matters referred to. As regards both (i) the lending of money and the giving of credit, and (ii) the varying of the terms on which money is lent or credit is given, the transaction has to be effected with reference to those matters. As regards (iii) the transaction has to be effected with a view to enabling or facilitating any such arrangement (that is the lending, giving or varying) concerning the lending of money

or the giving of credit. That, in our view, demonstrates that the transaction needs to be something different from the loan or credit arrangements themselves.

87. That, in our view, is the proper construction of s 786(1). It is necessary to identify, for s 786 purposes, a transaction outside the actual lending or giving of credit, or the variation of those terms. Accordingly, s 786(5) can apply only if there is such a transaction under which income is, relevantly for this case, forgone.

88. On this basis, the transaction cannot be the making of the Loan itself, the terms of which included the provision for the Borrower to issue the Shares to the Share Recipient. The fact that the Lender lent to the Borrower on those terms cannot therefore be regarded as the forgoing of income under any relevant transaction for s 786 purposes. The transaction which is effected with reference to the Loan is the actual issue of the shares by the Borrower to the Share Recipient. But under that transaction there is no forgoing by the Lender of anything. Although the Lender at that stage had the ability to enforce the performance of that obligation on the part of the Borrower, the Lender did not having any right, actual or putative, to any income under the Loan. There was nothing for the Lender to forgo under the transaction of the issue of the Shares to the Share Recipient.

89. For these reasons, therefore, we consider that s 786(5) did not apply so as to give rise to a charge to tax under Case VI of Schedule D on the Lender.

90. On that basis it falls to us to allow the Lender's appeal in that respect. However, in case we are found to have gone wrong in our analysis of s 786(5), we proceed to consider whether, even accepting HMRC's construction of that provision, its application would be precluded by virtue of s 80(1) and (5) FA 1996.

Application of s 80(1) and (5) FA 1996

91. As we have earlier briefly outlined, the FA 1996 introduced, in Chapter 2 of Part 4, a code for the application of corporation tax to loan relationships. It has been described, by Moses LJ in *Revenue and Customs Commissioners v DCC Holdings (UK) Ltd* [2010] STC 80, at [7], by reference to s 80(1) and (5) FA 1996, as "a discrete and exclusive code for the taxation of all the profits and gains of a company arising from its loan relationships".

92. Section 80(1) and (5) are as follows:

> "(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.
>
> …
>
> (5) Subject to any express provision to the contrary, the amounts which in the case of any company are brought into account in accordance with this Chapter as respects any matter shall be the only amounts brought into account for the purposes of corporation tax as respects that matter."

93. We can dispose of two points straight away. The first is that it was common ground that this does not have the effect that any exclusivity operates only if, under the loan relationships rules, there is a profit or loss of a positive amount. We agree. Thus, if an aspect of a loan relationship falls to be dealt with under Chapter 2, it makes no difference to the application of s 80(5) if the consequence of the loan relationships rules is that there is no profit, or a loss, rather than a positive taxable amount. The second is that there was equally no dispute that it was not the case that the mere existence of a tax charge under a provision outside the loan relationships code could represent an express provision to the contrary within s 80(5). With that we also concur.

94. The argument therefore focused on the meaning, in s 80(5), of "as respects any matter". Mr Prosser submitted that, in determining whether the matter dealt with by the loan relationships rules and that dealt with under s 786(5) ICTA are the same, it is necessary to identify the specific feature of the loan relationship that would give rise to a credit but for it not being recognised as a matter of generally accepted accounting practice. The answer, according to Mr Prosser, is that it is the issue, or the right the Lender has to the issue, of the Shares. Looking further at that issue, Mr Prosser argued that, when one looks at the reason why the Share issue is not brought into account, it is that the Lender has waived or forgone that income. This, argued Mr Prosser, was the same feature of the loan relationship that is sought by s 786(5) to be taxed. The income is income arising under a loan relationship, but it is not taxed under the loan relationships provisions because the Lender has waived or forgone it in a way that does not give rise to an accounting profit for the Lender.

95. In this respect, the arguments of Mr Ghosh and Ms Wilson are conveniently summarised in their skeleton argument. They say that in this case the "matter" scrutinised by s 786 is the forgoing of the income by the Lender on its loan relationship, and that that is not a matter dealt with by the loan relationships code at all. The loan relationships code deals with profits and losses arising from a company's loan relationships and related transactions. The forgoing of income by a company on a loan relationship is a different matter altogether, outside the scope of s 80(5).

96. In support of that argument before us, Mr Ghosh referred us to Sch 9 FA 1996, which contains special computational provisions. The general rule, in s 84, for the bringing into account credits and debits according to accounts prepared in accordance with GAAP, is expressly subject to those computational provisions (s 84(7)). Mr Ghosh argued that, whereas there were special provisions in Sch 9 dealing with releases (for example, under para 5 in relation to a debtor relationship, and under para 6 relating to impairment losses under a creditor relationship in certain connected party cases), there were, submitted Mr Ghosh, no such provisions dealing with the forgoing of income from the loan relationship.

97. In our judgment the approach urged upon us by Mr Ghosh is too narrow. It is not, in our view, focused on the matter that is addressed by the loan relationships code, but on the reason why, in the particular circumstances, the code operates in the way that it does. The purpose of Sch 9 FA 1996 is to override the more general

provisions of s 84 in certain specific circumstances. But it does not follow that, if a particular circumstance arising out of a loan relationship is not dealt with by Sch 9 (such as the forgoing of income), it does not represent a matter that has fallen to be brought into account in determining the accounting profit of the Lender under s 84. In our judgment no proper distinction can be drawn between an amount that falls as a general matter not to be treated as a credit or debit under s 84, and a matter that is expressly excluded from such treatment by virtue of a provision in Sch 9. If Mr Ghosh were correct, the logical conclusion to his argument would be that if releases had not been dealt with under Sch 9, but merely taken into account in determining accounting profits, those would also be outside the matters within s 80(5). That cannot be correct.

98. In our view, agreeing with Mr Prosser in this regard, the matter in respect of which the amounts were brought into account by the Lender was its Loan to the Borrower and the income arising on that Loan represented by the issue of Shares to the Share Recipient. All the characteristics of that Loan fell to be taken into account in determining, in accordance with GAAP, what sums fairly represented the profits, gains and losses of the Lender for the relevant accounting period, and accordingly the credits and debits that should be brought into account under s 84. That included the fact that the Lender did not receive the Shares itself, and the fact that it had the right to enforce the issue of the Shares to the Share Recipient. All the factors that would be in issue under s 786(5) required to be taken into account in arriving at the amounts in the Lender's accounts, and thus the credits and debits on the Lender's creditor relationship.

99. For these reasons, we conclude that even if, despite our earlier conclusion to the contrary, s 786(5) ICTA could give rise to a charge to tax on the Lender under Case VI of Schedule D, such a charge would be precluded by s 80(5) FA 1996.

The Share Recipient issue

100. It was common ground that the Share Recipient was not a party to a loan relationship and that, consequently, the loan relationship provisions of FA 1996 did not apply to it.

101. The issue for the Share Recipient is whether the value of the Shares issued to the Share Recipient forms part of the profits of the Share Recipient under Case VI of Schedule D. What HMRC say in this respect is that, if the diversion of the receipt of the Shares into the hands of another group member is effective to divest the Lender of any "asset", it must follow that the diverted income is taxable in the hands of the actual recipient, for whom the Lender enforces payment. Accordingly, it is said, the Shares are taxable as income in the hands of the Share Recipient. Such a receipt is accepted not to be taxable under Case III (s 18(3A) ICTA, which restricts the scope of Case III for corporation tax purposes), but is instead said to be taxable under Case VI.

102. Tax under Schedule D is charged by s 18 ICTA:

> "(1) The Schedule referred to as Schedule D is as follows—

Schedule D

Tax under this Schedule shall be charged in respect of—

(*a*) the annual profits or gains arising or accruing—

(i) to any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere, and

(ii) to any person residing in the United Kingdom from any trade, profession or vocation, whether carried on in the United Kingdom or elsewhere, and

(iii) to any person, whether a Commonwealth citizen or not, although not resident in the United Kingdom from any property whatever in the United Kingdom or from any trade, profession or vocation exercised within the United Kingdom, and

(*b*) all interest of money, annuities and other annual profits or gains not charged under Schedule A or under ITEPA 2003 as employment income, pension income or social security income, and not specially exempted from tax.

(2) Tax under Schedule D shall be charged under the Cases set out in subsection (3) below, and subject to and in accordance with the provisions of the Tax Acts applicable to those Cases respectively.

(3) The Cases are—

…

Case VI: tax in respect of any annual profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedule A or by virtue of ITEPA 2003 as employment income, pension income or social security income."

Additional findings of fact

103. We were invited by Mr Prosser to find, in respect of this issue, certain further facts which we could discern from consideration of the documents. We therefore make the following additional findings of fact, none of which were disputed by Mr Ghosh for HMRC:

(1) The Lender, Borrower and Share Recipient had common directors. It can be inferred therefore that the Share Recipient, through its directors, was aware of the loan agreement and its terms.

(2) The Share Recipient was not a party to the loan agreement. Further, clause 16 of the loan agreement provided that:

"A person who is not a party to this agreement has no right under The Contracts (Rights of Third Parties) Act 1999 to enforce any terms of this agreement, but this does not affect any right or remedy of a third party which exists or is available apart from that Act."

(3) On 18 December 2003, the Borrower repaid the Loan principal to the Lender and issued the Shares to the Share Recipient.

(4) The Shares were issued fully paid up, and the Share Recipient did not need to, and did not, pay or do anything in order to acquire the Shares.

(5) The Share Recipient did not apply for the Shares. This particular finding was necessary, having regard to some unfortunate drafting of the board minutes of the Share Recipient in respect of the board meeting on 18 December 2003. Those minutes referred to the approval by the board of an application by the Share Recipient for the Shares, and authorised the secretary of the company, amongst other things, to execute, deliver and perform such documents and other actions necessary in connection with the application. We accept, and Mr Ghosh raised no objection, that this drafting was a simple error, and that no such application was required or made.

(6) The Shares were very valuable.

(7) The Shares were not onerous or burdensome to the Share Recipient in any way.

(8) The directors of the Share Recipient decided that it was in the company's best interests to acquire the Shares. This appears from the board minutes of 18 December 2003. Again, with no dispute from Mr Ghosh, we are content to accept that, despite the dubious drafting of those minutes generally.

(9) The Share Recipient did not disclaim the Shares, and became the owner of them.

Case VI: the source doctrine

104. Mr Prosser argued that, whatever the nature of the receipt in the hands of the Share Recipient, it was not income taxable under Case VI of Schedule D. There was no taxable source of that receipt, with the result that it was not taxable income, but was instead a receipt of a capital nature. To be of the nature of income a receipt must have a source and be distinct from that source.

105. We are therefore here concerned with whether, on the facts of this case, the Share Recipient had a source of income from which the Share issue was derived, so as to be a receipt of income under Case VI. We start by looking at the source doctrine as a well-established, and indeed fundamental, principle of tax law. But before doing so we should note that, for the purposes of these appeals, HMRC did not seek to argue that the source doctrine does not apply to Case VI; they nevertheless wished to make it clear that this point was not generally conceded, and that they reserved the ability to argue to that effect in other proceedings.

106. In *Brown v National Provident Association* 8 TC 57, one of the questions was whether discounts on certain Treasury Bills could be subject to taxation, on a preceding year basis, for a year in which the taxpayer did not hold or have any transactions in the relevant securities. It was held, upholding the special commissioners, by both the Court of Appeal and by a majority of the House of Lords,

that tax could not be charged on that basis. In the Court of Appeal Lord Sterndale MR said (at p 73):

> "It seems to me to be a general principle of Income Tax Law that a person in order to be taxable in a particular year must have an income arising from a source existing in that year and in order to justify this assessment the Crown must show some reason for departing from that general principle. It is admitted that if the taxation be in respect of a trade, or business, or an office, or of property the taxpayer must continue in the year of charge to carry on the trade or business or hold the office or the property. It was, however, contended for the Crown that the principle did not apply in this case because by the first rule of the Third Case the duty to be charged was computed according to the profits of the preceding year, and, therefore, if the last year was not taxed because there was no source, one year escaped taxation altogether. I do not think the first rule has this effect. The provision as to computation of profits is the same as that in respect of trades, etc., in the first rule of the First Case, and it is admitted that in that instance the trade must exist in the taxable year in order to make the taxpayer liable. I see no reason for construing the same provision in a different way in the two rules; both refer to methods of computation only, and are not directed to whether there is a taxable income or not. Besides, as pointed out in Dowell's Income Tax Laws, 7th Edition, page 300, the Third Case originally dealt with property which must have existed in the hands of the taxpayer in the taxable year in order to make him liable, and it can hardly have been intended by the insertion of the second rule to alter the effect of the first. if the first year does escape taxation, it is because the Legislature has not inserted in the second rule of the Third Case such a provision as is found in the first rule of the First Case. It is suggested by the Commissioners that the profits of the first year might be taxed under the Sixth Case. I do not think it necessary to decide that point, for even if they be not taxable it does not in my opinion show that the taxpayer can be taxed in respect of a source of income which does not exist."

107. In the House of Lords, Viscount Haldane agreed, observing (at p 85) that "the general principle of the Acts is to make the tax apply only to a source of income existing in the year of assessment". The tax was intended as a matter of basic principle to be on profits and gains forming income in the year of assessment, though measured by the income, not of that year, but of the preceding year.

108. More recently, in *Pumahaven Ltd v Williams* [2002] STC 1423, in dealing with a refusal on the part of the special commissioner to postpone payment of tax, where one of the grounds relied upon in the appeal was that a payment was not taxable because it had been received from a source that the taxpayer company no longer possessed in the year of assessment of receipt, Park J offered the following description of the source doctrine (at [19] to [20]):

> "[19] The source doctrine argument relied on a general principle of tax law that, given the schedular structure of the United Kingdom income tax and corporation tax on income, and given also that income tax and

> corporation tax on income are annual taxes, taxpayers are not taxed on income in the general sense of the term, but rather on specified kinds of income from specified sources.
>
> [20] Further, and critically for the argument in this case, the taxpayer must possess the sources in the year of assessment or accounting period in which the income arises. If the taxpayer receives income from a source which the taxpayer no longer possesses in the year or accounting period of receipt, the effect of the source doctrine is that, in principle and subject to any detailed statutory provision to the contrary, the income is not taxable."

109. As Mr Prosser put it, the continuing relevance of the source doctrine can also be illustrated by *Revenue and Customs Commissioners v Bank of Ireland Britain Holdings Ltd* [2008] STC 253. The case concerned, in part, the question of the proper interpretation of s 730A ICTA in respect of tripartite repo arrangements under which the original purchaser of the securities under the repo ("the interim holder") sold those securities to a third party ("the reseller"), with the obligation to re-sell the securities to the repurchaser . Under s 730A, the excess of the repurchase price over the sale price was treated as a payment of interest made by the repurchaser on a deemed loan from the interim holder of an amount equal to the sale price. It was held that the deemed interest was taxable, if at all, in the hands of the interim holder, as the owner of the source (albeit a deemed source) from which the taxable interest could arise. The repurchaser, by contrast, was not taxable.

110. In reaching this conclusion, Henderson J in the High Court (at [31] said:

> "The deemed loan is still from the interim holder, notwithstanding the tripartite nature of the arrangements, and that deemed loan is the only source (albeit a deemed source) from which taxable interest can arise. The interest must therefore be taxable in the hands of the owner of that source (the interim holder), whether or not the interim holder also receives the repurchase price. The legislative scheme, for better or for worse, is to treat the interim holder as the deemed lender of the original sale price for the life of the repo, and it is therefore in the hands of the interim holder that the deemed interest is taxable."

111. Further, in response to an argument by counsel to the Crown that s 730A did not identify the deemed recipient of the interest, Henderson J said (at [34]):

> "Nor do I agree that a person other than the original lender can be taxable on the interest from a loan, unless the taxable source itself has been transferred. A mere direction to pay the interest to a third party, for example, or a mere assignment of the right to receive the interest without an assignment of the underlying loan agreement itself, would not, as I understand it, suffice to make the third party taxable on the interest in place of the original lender."

The source doctrine was fundamental, in that it required the legislation to refer to the deemed loan as providing the necessary link between the notional interest and the charging provisions. The deemed loan was therefore of fundamental importance in bringing the notional interest into charge to tax (see [36]).

112. The Court of Appeal dismissed HMRC's appeal. In giving the leading judgment (with which Sir William Aldous and Maurice Kay LJ agreed), Collins LJ held that there was nothing that could displace the fact that the ordinary meaning of the words of the statute plainly pointed to the payment of interest as being to the interim holder. As regards source, he said (at [46] to [47]:

> "[46] This conclusion is also supported by, but is not dependant upon, BH's argument that the law has required that a source of income be identified before the income itself can be taxed: *Brown v National Provident Institution; Ogston v Provident Mutual Life Association* [1921] 2 AC 222, 8 TC 57.
>
> [47] Receipt, of itself, is not a determinant of any possible tax liability. An assignee of the right to receive interest (without assignment of the loan relationship) would not be taxable on the amount of that interest under the loan relationship provisions because he has no relevant loan relationship."

113. The importance of there being a continuing source from which the receipt is derived in order for it to be a taxable receipt has been demonstrated in a number of cases. One, in the context of Schedule E, is *Bray v Best* [1989] STC 159. In that case employees of a company were transferred to the employment of the parent company. In a subsequent tax year the taxpayer, Mr Best, was allocated certain sums out of trusts for the benefit of the original company's employees. In giving judgment in the House of Lords, Lord Oliver referred, at p 164f-h, to the well-established principle, deriving from the nature of income tax as an annual tax, that a receipt or entitlement arising in a year of assessment is not chargeable to tax unless there exists during that year a source from which it arises. As there was no material feature that would indicate that the payments to Mr Best fell to be attributed to any year during which he was employed by the company, those sums were not taxable.

114. In *Property Co v Inspector of Taxes* [2005] STC (SCD) 59, the special commissioners considered a number of issues arising out of arrangements entered into by the taxpayer company which resulted in the company receiving rent after the relevant leases had been transferred to another company in the same group. The relevant issue for present purposes was whether the rent retained by the taxpayer company was not taxable under Schedule A on the ground that no source was possessed during the accounting period in question. It was held that the Schedule A source had ceased, and that accordingly the retained rents could not be taxed under that Schedule.

115. That was the end of the matter in relation to one of the payments in issue. Because that payment retained its characteristic as rent, it could be taxable only under Schedule A, and not under Case VI of Schedule D. But another purported retention of rent was void under certain statutory provisions, and was instead made under a contractual right. It was not rent and had no legal connection with land. The payment was therefore in the nature of income that was *ejusdem generis* with Schedule A income and, not being taxable under any other Schedule, was taxable under Case VI of Schedule D.

116. What is clear from all these cases is the necessity for there to be a source in the particular year of assessment in which the income is said to arise. The nature of the source depends on the particular Schedule under which the income would fall to be assessed. In certain cases, such as Schedule E or Case I of II of Schedule D, the source will be something carried on, in the nature of an employment or a trade or profession. Where that activity continues to be carried on, there will be a continuing source, and receipts derived from that source for a period in which it exists, whether they are receipts that are obtained by way of right or entitlement, or are purely voluntary, will be taxable.

117. Thus, in *Bray v Best*, payments out of the trusts in years when the employment with the original company was continuing were taxable, although the taxpayer had no right to require the payments to be made. Voluntary payments for the purpose of supporting a trade were likewise held to be taxable in *IRC v Falkirk Ice Rink Ltd* [1975] STC 434. These cases can, however, be contrasted with that of *Stedeford v Beloe* 16 TC 505, where an annual pension voluntarily awarded to the retired headmaster of Bradfield College was held not to be taxable. It was not taxable under Schedule E because the taxpayer no longer held the office of headmaster; it was not taxable under Schedule D because, as a mere voluntary gift, it was not, in the true sense of the word, income (see, per Viscount Dunedin, at p 521). A distinction was drawn between the voluntary nature of those arrangement and the case of *Duncan v Farmer* 5 TC 417, on the basis that in the latter case the taxpayer had given consideration for the annuity, and could have sued for it.

118. That does not mean that the absence of an enforceable right is decisive. It was argued in *Lindus & Hortin v IRC* 17 TC 442 that a payment to a beneficiary of a discretionary trust was in the nature of a voluntary gift and in substance came within the principle of the decision in *Stedeford v Beloe*. It was held in the High Court by Finlay J that it was the relationship of trustees and *cestui que trust* (beneficiary) that constituted the payments income of the recipient, and that it did not matter whether the payments were made because the trustees were directed by the trust deed to make them or they were made as a matter of discretion; once they were made to the beneficiary they became income of the beneficiary.

119. A similar distinction was made in *Cunard's Trustees v IRC* 27 TC 122 between voluntary payments and payments made in the exercise by trustees of a will to a beneficiary during the administration period. The argument on the part of the taxpayer that those payments were purely voluntary and not claimable by the taxpayer as of right, and that they were accordingly not taxable, was rejected. As Lord Greene expressed it (at p 133-134), the payments were not voluntary in any relevant sense, but were made in the exercise of a discretion conferred by the will out of a fund provided for the purpose by the testatrix. The trustees were bound to consider exercising their discretion. The fact that they might have concluded to decline to make a payment did not give the payment the character of a voluntary payment. The money, when received by the beneficiary, was received by her through the joint operation of the will and the exercise of their discretion by the trustees.

120. We are concerned in this case with the question of the application of Case VI of Schedule D. The scope of that Case was considered by Rowlatt J *in Ryall v Hoare* 8 TC 525. Having ruled out anything in the nature of a capital accretion, including a casual profit made on the isolated buying and selling of an article outside the carrying on of a trade, Rowlatt J said (at p 525):

> "'Profits or gains' mean something which is in the nature of interest or fruit, as opposed to principal or tree. The other class of case that one can rule out is that of gifts. A person may have an emolument by reason of a gift *inter vivos* or testamentary, or he may acquire an emolument by finding an article of value or money, or he may acquire it by winning a bet. It seems to me that all that class of cases must be ruled out, because they are not profits or gains at all. Without pretending to give an exhaustive definition, I think one may take it as clear that where an emolument is received, or, rather, where an emolument accrues, by virtue of some service rendered by way of action or permission, or both, at any rate that is included within the words 'profits or gains.'"

121. It was common ground that to fall within Case VI a receipt must be of an income nature and must be analogous to those profits or gains falling within the preceding Cases of Schedule D (see, per Viscount Dunedin, in *Leeming v Jones* 15 TC 333, at p 359), or any other Schedule. It has also been accepted, for the purposes of this case, that the income receipt must have a source.

122. What Mr Prosser argued was that, viewed from the perspective of the Share Recipient, its receipt of the Shares was simply a one-off gift which, understandably, it accepted. It was argued that the Share Recipient had no right against any person, whether to acquire the Shares or otherwise. The Share Recipient was not a party to the loan agreement, and any rights that the Share Recipient might have had to enforce the agreement under the Contracts (Rights of Third Parties) Act 1999 had been excluded. On this basis, Mr Prosser submitted, there was no source for the receipt of the Shares by the Share Recipient, and no charge under Case VI of Schedule D could arise.

123. Mr Ghosh submitted that the issue of the Shares by the Borrower to the Share Recipient was a payment of interest, or, as an alternative, that it was analogous to a payment of interest. In support of his primary submission he referred us to the well-known description of Megarry J in *Re Euro Hotel (Belgravia) Ltd* [1975] STC 682 where, after reviewing the relevant case law, he said (at p 691):

> "It seems to me that running through the cases there is the concept that as a general rule two requirements must be satisfied for a payment to amount to interest, and a fortiori to amount to 'interest of money'. First, there must be a sum of money by reference to which the payment which is said to be interest is to be ascertained. A payment cannot be 'interest of money' unless there is the requisite 'money' for the payment to be said to be 'interest of'. Plainly, there are sums of 'money' in the present case. Second, those sums of money must be sums that are due to the person entitled to the alleged interest; and it is this latter

> requirement that is mainly in issue before me. I do not, of course, say that in every case these two requirements are exhaustive, or that they are inescapable. Thus I do not see why payments should not be 'interest of money' if A lends money to B and stipulates that the interest should be paid not to him but to X: yet for the ordinary case I think that they suffice."

124. Although Mr Prosser pointed out that this description was given in the context of a question whether certain payments should have been made under deduction of tax, we do not consider that the remarks of Mr Justice Megarry were intended to be, or should be, confined to that narrow compass. In this case the number of Shares to be issued was determined so as to represent a return at a commercial rate of interest on the Loan. In our view, those shares were interest on that Loan, and they are not prevented from being interest by reason of having been issued to the Share Recipient and not to the Lender.

125. The character of the payment does not, of course, determine whether it has the requisite source, and is thus taxable income. In this respect Mr Ghosh submitted that source was really a question of status. It looks to the capacity in which the recipient has received a payment. Thus, for example, Schedule A concerns whether the potentially taxable receipt arose to a person in that person's capacity as the holder of an interest in land; Schedule D, Cases I and II concerns whether the receipt arose in the capacity of a trader or person carrying on a profession; and Schedules E and F are concerned with a person's capacity as an employee and shareholder respectively. In this case, Mr Ghosh submitted that the capacity of the Share Recipient was as the counterparty to an obligation of the Borrower to issue the Shares under the loan agreement, and that that was accordingly a source of the receipt of the Share Recipient.

126. In our judgment, in seeking to ascertain whether a receipt has a source so as to render it taxable income, it is necessary to discover how the entitlement to that receipt, once made, has arisen. We accept, because it is covered by authority such as *Stedeford v Beloe*, that a purely voluntary payment cannot have a source for this purpose. But, as the cases show, that does not mean that, for there to be a source, the recipient must have a right, still less an enforceable right, to the payment before it is made.

127. We do not accept that the Shares were simply a one-off gift to the Share Recipient. If the Lender had simply made a gift of the Shares themselves to the Share Recipient, we would have agreed that this would not have been a taxable receipt. Although Mr Prosser argued that, from the perspective of the Lender, by directing that the Shares were to be issued, not to the Lender, but to the Share Recipient, that was a gift made by the Lender, that is not the perspective that is material for these purposes. The issue of the Shares was by the Borrower to the Share Recipient. The Borrower was under a contractual obligation, albeit not to the Share Recipient, to issue the Shares to the Share Recipient. In fulfilling that obligation, it cannot be regarded as having made a gift. It is true that it could have decided to breach the terms of the loan agreement, but that does not make the issue of the Shares on its part a voluntary act.

128. In this case the Lender did not simply make a gift of the Shares to the Share Recipient. The means adopted by the Lender to enable the Share Recipient to receive the Shares was the creation of an obligation on the part of the Borrower under the loan agreement. If the Borrower had chosen not to fulfil that obligation, and the Lender had not enforced it, the Share Recipient would have received nothing. No tax liability would have arisen to the Share Recipient. But the Shares, when received by the Share Recipient, were derived from the loan agreement, and the obligation of the Borrower under that agreement.

129. In our judgment, these circumstances are close to those in *Lindus & Hortin* and *Cunard's Trustees*. To adopt the language used in *Cunard's Trustees*, the issue of the Shares was not voluntary in any relevant sense but was made by the Borrower in fulfilment of its obligation under the loan agreement which had been imposed on it by the Lender. The Shares, when received by the Share Recipient, were received by it through the operation of the loan agreement and the decision on the part of the Borrower to comply with its obligations under that agreement.

130. It follows from this that, in our view, the source of the issue of the Shares was the loan agreement. The Share Recipient had an entitlement under that agreement because of the obligation of the Borrower under that agreement to issue the Shares to the Share Recipient. That connection is, in our view, sufficient to render the loan agreement a source of the Share Recipient. As the Shares were interest on the Loan, and were not taxable on the Share Recipient under Case III of Schedule D because the Share Recipient is not taxable under the loan relationships provisions of FA 1996, the receipt of the Shares by the Share Recipient is taxable under Case VI of Schedule D.

131. We are not deflected from this conclusion by any of the language used in the authorities to which we have been referred. Although it is common to refer, as Park J did in *Pumahaven*, to the need for the taxpayer to "possess" the source, that is in our view merely a way of describing the necessary connection there must be between the taxpayer and the source from which the income in question has arisen. It may refer to actions, such as the carrying on of a trade, to legal relationships such as that of employment, or to a property interest, such as an interest in land. But it does not, as cases such as *Lindus & Hortin* and *Cunard's Trustees* demonstrate, require ownership, or any right, whether contractual or otherwise, to enforce the making of the relevant payment. The existence of such a right might, as was the case in *Stedeford v Beloe*, enable one to distinguish between cases that do amount to purely voluntary payments and those that do not, but, as the authorities show, the existence or enforceability of a right is not an essential ingredient in making that distinction.

132. Nor do we consider that *Bank of Ireland Britain* contains anything to the contrary. That was a case concerned with the effect of the deeming provision of s 730A ICTA. There was no scope to go beyond the deemed loan, and consequently the interim holder as the only possible lender and recipient of the deemed interest in the form of the repurchase price, in order to treat the assignee (the reseller) of the relevant securities as the recipient of the deemed interest. To the extent that the source doctrine supported that analysis, it was in our view confined to identifying the deemed loan as the source which provided the necessary link between the notional

interest and the relevant charging provisions. The legislation recognised that mere receipt of deemed interest would not be enough, and that the source of the deemed interest needed to be identified. We consider that the references made by Henderson J at [34] to an assignment of the right to receive interest without an assignment of the underlying loan agreement itself as not sufficing to make the assignee taxable on the interest in place of the original lender are intended to refer to the position under FA 1996 which Collins LJ described in the Court of Appeal at [47]. We do not consider that the remarks go further than that or that they can affect the conclusion we have reached in this case as to the liability of the Share Recipient under Case VI of Schedule D.

Reward for participation in tax scheme

133. In view of our conclusion on the source of the Share Recipient's receipt of the shares being the loan agreement, we do not have to reach a conclusion on an alternative argument of Mr Ghosh and Ms Wilson, that the Shares were Case VI income as a reward to the Share Recipient for playing its part in a tax scheme. We had very little argument on this alternative submission; it was put more by way of assertion than reasoned argument. But we should for completeness say a few words about it.

134. The basis of Mr Ghosh's argument was that the issue of the Shares to the Share Recipient was a receipt in respect of a facility provided by the Share Recipient to the Borrower or to the Lender or to the relevant corporate group as a whole. As such the receipt was chargeable under Case VI of Schedule D by analogy with trading income.

135. We reject that submission for two reasons. The first is that, on the facts of this case we can see nothing in what the Share Recipient did that could lead to any proper analogy with the carrying on of a trade or profession. The role of the Share Recipient was passive, and we do not consider that a failure to do something, for example, to disclaim the Shares, could be regarded as having any similarity to a trading or professional activity.

136. Secondly, we agree with Mr Prosser that the issue of the Shares could not be regarded as a reward, or in any sense as a *quid pro quo*, for the Share Recipient's participation in the tax scheme. That participation consisted entirely of the Share Recipient receiving the Shares. That receipt was therefore the activity for which it is said the issue of the Shares was the reward. That in our view is not a tenable analysis.

137. Finally, we agree with Mr Prosser that the fact that we are dealing with a tax scheme, and the Share Recipient was part of that scheme, does not affect the Case VI analysis.

138. We conclude therefore that HMRC's alternative case on the application of Case VI of Schedule D to the Share Recipient must fail.

Unallowable purposes

139. Independently of the other issues in this case, HMRC contend that no part of the loan relationship debit referable to the issue of the Shares by the Borrower to the Share Recipient should be brought into account by the Borrower. That contention is founded upon the unallowable purposes provisions of paragraph 13 of Schedule 9 FA 1996, which relevantly provides as follows:

> "(1) Where in any accounting period a loan relationship of a company has an unallowable purpose,—
>
> *(a)* the debits, and
>
> …
>
> which, for that period fall, in the case of that company, to be brought into account for purposes of this Chapter shall not include so much of the debits … given by the authorised accounting method used as respects that relationship as, on a just and reasonable apportionment, is attributable to the unallowable purpose.
>
> (1A) Amounts which, by virtue of this paragraph, are not brought into account for the purposes of this Chapter as respects any matter are in consequence also amounts which, in accordance with section 80(5) of this Act, are not to be brought into account for the purposes of corporation tax as respects that matter apart from this Chapter.
>
> (2) For the purposes of this paragraph a loan relationship of a company shall be taken to have an unallowable purpose in an accounting period where the purposes for which, at times during that period, the company—
>
> *(a)* is a party to the relationship, or
>
> …
>
> include a purpose ("the unallowable purpose") which is not amongst the business or other commercial purposes of the company.
>
> (3) For the purposes of this paragraph the business and other commercial purposes of a company do not include the purposes of any part of its activities in respect of which it is not within the charge to corporation tax.
>
> (4) For the purposes of this paragraph, where one of the purposes for which a company—
>
> *(a)* is a party to a loan relationship at any time, or
>
> …
>
> is a tax avoidance purpose, that purpose shall be taken to be a business or other commercial purpose of the company only where it is not the main purpose, or one of the main purposes, for which the company is a party to the relationship at that time …
>
> (5) The reference in sub-paragraph (4) above to a tax avoidance purpose is a reference to any purpose that consists in securing a tax advantage (whether for the company or any other person).

(6) In this paragraph—

"tax advantage" has the same meaning as in Chapter I of Part XVII of the Taxes Act 1988 (tax avoidance)."

140. As described earlier, the way the issue has been put to us is a little unusual. We have not been provided with all the facts, nor have we heard evidence referable to the unallowable purposes issue. Instead, we are asked to determine whether HMRC's argument must succeed on the basis of certain agreed facts only, and irrespective of any other facts which we might have found had we been presented with further factual evidence.

141. The three facts on which it is contended by HMRC that we must come to the inevitable conclusion that para 13 operates to deny the Borrower the loan relationship debit are:

(a) The only reason for the borrowing's design, structure and terms was to obtain a tax advantage for the Lender and/or Share Recipient (in that the entirety of any payments made by the Borrower would escape tax altogether in the hands of the Lender and the Share Recipient).

(b) The lender, the Share Recipient and the Borrower all knew at the time of entering into the borrowing that the borrowing was designed and structured so that the Lender and/or the Share recipient would obtain the tax advantage.

(c) The Borrower had a commercial need for the borrowing.

142. We should stress that the question is not whether, had these been the *only* facts before us, we would conclude that para 13 applied. The question is whether the presence of those facts set out at (a) and (b) above makes it inevitable that para 13 would disallow the debit, whatever other facts might have been found.

143. For HMRC, Mr Ghosh and Miss Wilson submitted that the law could be summarised in the following way. First, it is a question of fact whether a company has an unallowable purpose in being a party to a loan relationship. Secondly, purpose means subjective purpose. Thirdly, "main" simply means "important". Fourthly, trying to achieve a tax advantage for someone else is an unallowable purpose. Fifthly, the just and reasonable exercise looks at the purpose of the borrower, and the actual loan relationship entered into.

144. The argument proceeds that in being a party to a loan relationship, which the Borrower knew would have the inevitable consequence of securing a tax advantage (for the Lender and/or for the Share Recipient), the Borrower must have had an intention to secure a tax advantage, and such an intention could not be distinguished from the Borrower's subjective purpose. That purpose was an important, and thus a main, purpose.

145. In support of the argument that the inevitable consequence of the tax advantage would necessarily translate into a purpose of the Borrower the secure that tax advantage, and thus be a tax avoidance purpose, Mr Ghosh and Ms Wilson referred us

to the decision of the VAT and Duties Tribunal in *Coffee Republic PLC v Revenue and Customs Commissioners* (VAT Decision 2150). That was a case concerning whether certain food had been heated for the purpose of enabling it to be consumed at a temperature above ambient air temperature; if so, then its supply when hot would be a standard rated supply for VAT (and not zero-rated). The purpose therefore fell to be ascertained. The appellant argued that its purpose in heating the products was not to enable them to be consumed hot, but to supply them in a crisp or toasted state, to melt cheese and to make the products more visually appealing.

146. The tribunal found that enabling the product to be consumed hot was the dominant purpose of the appellant in heating it. In making this finding the tribunal weighed the different purposes for which the products were heated. The purpose of enabling a crisp, freshly toasted product to be consumed was held not to carry with it the purpose that it be hot when consumed. On the other hand, the purpose of enabling melted cheese to be consumed did carry with it the coextensive purpose of enabling the product to be consumed hot.

147. In reaching its conclusions, the tribunal noted that there was a distinction between an inevitable result of the successful completion of a purpose and something which is necessary for or part of a stated purpose. The tribunal offered, at [54], the following analogy:

> "If with intent a person kills a fly by squashing it, it cannot be said that because his avowed purpose was 'to kill the fly', it was not also to squash it. His purposes may stop short at the killing: his purpose of killing the fly by squashing does not mean that he had a purpose of leaving a mess on the window, but it must encompass the intended means of achieving the killing."

148. It was on this basis that the tribunal was able to draw a distinction between the intention to provide a product that was crisp and the intention to enable the cheese to be consumed in a melted state. In the former case the intention encompassed a purpose of heating the product, but not that of enabling it to be consumed hot, even though that was a consequence. In the latter case, the means of achieving the purpose of enabling the cheese to be consumed in a melted state was to enable the cheese, and thus the product, to be consumed hot.

149. In our view, *Coffee Republic* does not support HMRC's argument. It points in the opposite direction. It suggests that, if the purpose of a borrower was to achieve tax avoidance by entering into a loan relationship, it could be said that the borrower had a purpose of entering into the loan relationship, because that was the means by which the tax avoidance purpose would be achieved. The tax avoidance purpose equates to the killing of the fly, and the loan relationship is the squashing if it. But the converse does not hold. The fact that a tax advantage is an inevitable consequence of the entry into the loan relationship does not mean that it is a purpose of the borrower, even if he knows that will be a consequence; the tax advantage is merely the mess on the window.

150. This distinction between purpose and effect is well-known. Mr Prosser and Mr Henderson referred us to the speech of Lord Brightman in *Mallalieu v Drummond* 57 TC 330, and in particular to the following passage (at pp 365H-366C):

> "The object of the taxpayer in making the expenditure must be distinguished from the effect of the expenditure. An expenditure may be made exclusively to serve the purposes of the business, but it may have a private advantage. The existence of that private advantage does not necessarily preclude the exclusivity of the business purposes. For example a medical consultant has a friend in the South of France who is also his patient. He flies to the South of France for a week, staying in the home of his friend and attending professionally upon him. He seeks to recover the cost of his air fare. The question of fact will be whether the journey was undertaken solely to serve the purposes of the medical practice. This will be judged in the light of the taxpayer's object in making the journey. The question will be answered by considering whether the stay in the South of France was a reason, however subordinate, for undertaking the journey, or was not a reason but only the effect. If a week's stay on the Riviera was not an object of the consultant, if the consultant's only object was to attend upon his patient, his stay on the Riviera was an unavoidable effect of the expenditure on the journey and the expenditure lies outside the prohibition in s 130."

151. The same theme can be found in the case of *McKnight v Sheppard* [1999] STC 669, where the fact that the taxpayer was found to be concerned as to his personal reputation when he incurred expenses in defending certain disciplinary proceedings, did not mean that the preservation of that reputation was necessarily a purpose of such expenditure. Referring to the passage from Lord Brightman's speech in *Mallalieu v Drummond* we have just quoted, Lord Hoffman said (at p 673f-g):

> "If Lord Brightman's consultant had said that he had given no thought at all to the pleasures of sitting on the terrace with his friend and a bottle of Côtes de Provence, his evidence might well not have been credited. But that would not be inconsistent with a finding that the only object of the journey was to attend upon his patient and that personal pleasures, however welcome, were only the effects of a journey made for an exclusively professional purpose. This is the distinction which the commissioner was making and in my opinion there is no inconsistency between his conclusion of law and his findings of fact."

152. In a different context, the question in *IRC v Sema Group Pension Scheme Trustees* 74 TC 593 was whether one of the main objects of sales of shares by a pension fund back to the company that had issued the shares was to enable tax advantages to be obtained. The tax advantage in question was the tax credit attaching to the distribution to which such a sale gave rise. It was found as a fact that a main reason for the trustees' decision to offer to sell the shares to the company was the availability of the tax credit, which alone made the price obtainable acceptable. Although allowing the pension fund's appeal on other grounds, the special commissioners had held that the tax credits were crucial to the decision to sell into the

buy-backs and so one of the main objects of the sales was to enable tax advantages to be obtained.

153. The decision of the special commissioners in this respect was upheld, as a finding of fact, in both the High Court and the Court of Appeal. Both referred to the principle established *in IRC v Brebner* 43 TC 705, where Lord Upjohn said (at p 718-9):

> "My Lords, I would only conclude my judgment by saying, when the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out - one by paying the maximum amount of tax, the other by paying no, or much less, tax - it would be quite wrong as a necessary consequence to draw the inference that in adopting the latter course one of the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved. The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners to decide upon a consideration of all the relevant evidence before them and the proper inferences to be drawn from that evidence."

154. That is, we consider, a clear statement of the correct approach to be adopted in considering whether something is a main object, or a main purpose, of a transaction or of a party to the transaction. As Lord Upjohn also said in *Brebner* (at p 718), that is a matter of the intention of the parties. The mere fact that tax informs the choice of transaction does not itself give rise to a necessary inference that the obtaining of a tax advantage was a main object or purpose. Such an inference may, of course, be drawn, but that will depend, as it did in *Brebner*, on the findings of fact made on consideration of all the relevant evidence. The point was further emphasised by Lightman J in *Sema* in the High Court when, having considered submissions on *IRC v Kleinwort Benson Ltd* 45 TC 369, he said (at p 637, para 53):

> "The observations of Cross J. call attention to the need when determining whether the obtaining of a tax advantage was a main object of an ordinary commercial transaction, to consider with care the significance to the taxpayer of the tax advantage. The tax advantage may not be a relevant factor in the decision to purchase or sell or in the decision to purchase or sell at a particular price. Obviously if the tax advantage is mere "icing on the cake" it will not constitute a main object. Nor will it necessarily do so merely because it is a feature of the transaction or a relevant factor in the decision to buy or sell. The statutory criterion is that the tax advantage shall be more than relevant or indeed an object; it must be a main object. The question whether it is so is a question of fact for the Commissioners in every case."

155. This passage was considered by the special commissioners in *Prudential plc v Revenue and Customs Commissioners* [2008] STC (SCD) 239, a case relied upon by Mr Ghosh in support of his proposition that "main" simply means "important". To the extent that Mr Ghosh's submission would result in the question of importance being considered in isolation from all other factors, we disagree, and we do not

consider that *Prudential* provides any support for it. What is important, in our view, is that the significance of the tax advantage to the taxpayer must be considered as a matter of subjective intention, which necessarily involves a careful analysis of all the reasons the taxpayer had for entering into the transaction. That was, indeed, the approach adopted in *Prudential* itself, which involved a thorough analysis of the decision of the Prudential to invest "idle cash" as a front end payment in a tax driven scheme. It followed the approach of Lightman J in *Sema* in finding that, at least in one respect, the tax advantage was more than mere icing on the cake.

156. This analysis is consistent with the approach adopted by the First-tier Tribunal in considering the main purpose test in para 13. In *A H Field (Holdings) Ltd v Revenue and Customs Commissioners* [2012] UKFTT 104 (TC), the tribunal rejected arguments for the taxpayer to the effect that purpose should not be inferred from consequences, and that a distinction should be drawn between intentional purposes and inevitable consequences. In adopting the approach set out in *Brebner*, *Sema* and *Prudential*, the tribunal focused on "the components of [the relevant] decision [to enter into the loan] by reference to these particular facts and circumstances, taking account of both the alleged purposes by reference to the available evidence and actual consequences of the [taxpayer's] actions (*Field*, para 139).

157. The tribunal went on to reject a further submission for the taxpayer that a commercial purpose would always cancel out any fiscal purpose. The tribunal said (at para 170):

> "In determining whether this tax avoidance purpose was a main purpose, we do not agree with Mr Southern [counsel for the taxpayer] that a commercial purpose will always cancel out any fiscal purpose. Whether it does so depends on the weight given to the commercial purpose. Mr Southern suggests that commercial purposes have some greater intrinsic weight than tax purposes, because any commercial purpose will always trump a fiscal purpose. We do not find anything in the drafting of paragraph 13 or in any of the case authorities referred to, to suggest that this is the correct approach."

The tribunal then went on to say, at para 173, that in order to decide whether para 13 applies it is not enough to point to the commercial purpose of the taxpayer; it is necessary to weigh up all the relevant factors which, on the basis of the evidence, the taxpayer took into account in coming to the decision to take a particular course of action, having regard both to the commercial and tax considerations.

158. In our respectful view, that is the correct approach to the requirement under para 13 to identify, in the first place, a purpose of the taxpayer, and secondly to determine whether that purpose is a main purpose. In the same way that the mere presence of a commercial purpose cannot rule out the existence of tax avoidance as being a main purposes, the mere existence of a tax advantage, known to the taxpayer, does not on its own render the obtaining of that advantage a main purpose. All the authorities point to the question being one of degree and significance to the taxpayer, and that the question is one of fact for the tribunal, having regard to all the circumstances.

159. We do not accept Mr Ghosh's submission that the balancing exercise is relevant only to the second stage of the enquiry under para 13, namely the just and reasonable apportionment exercise whereby the loan relationship debit is excluded only to the extent that it is attributable to the unallowable purposes. Whatever the merits of such an approach in terms of simplicity, predictability and consistency, which Mr Ghosh urged upon us, that would not in our view be the approach that has been adopted by the scheme of the legislation. The threshold requirement that the tax avoidance purpose should be one of the main purposes of the taxpayer company in entering into the transaction is one that, on authority, can only be met by reference to a full factual enquiry as to the intentions of the taxpayer, and the significance to the taxpayer of any tax avoidance purpose identified.

160. We therefore find that a full factual enquiry is necessary in order to ascertain whether the securing of a tax advantage for the Lender and/or Share Recipient was a main purpose of the Borrower within para 13. It does not necessarily follow, without taking into account all the factual context and the relevant circumstances, from the fact that the only reason for the design, structure and terms of the borrowing was to obtain such a tax advantage, and that the parties, including the Borrower, knew that was the case, that the Borrower has a tax avoidance purpose which is a main purpose within the meaning of para 13.

161. Our answer to the first part of the question put to us on the unallowable purposes issue is accordingly "no".

162. The second part of the question, which concerns whether, on a just and reasonable apportionment, the postulated facts would entail that the whole of the Borrower's loan relationship debit would necessarily (irrespective of any other facts) be attributed to the unallowable purpose, is relevant only if we had given a positive answer to the first part of the question. It does not therefore require determination by us. However, we shall address it, if briefly, in view of the submissions made in that respect.

163. Mr Ghosh submitted that the apportionment question should be approached by considering how much greater the debit is because of the tax avoidance purpose. The relevant comparator for this purpose is not with another, different, transaction that the taxpayer could have entered into, but with the debit that would have been achieved if there had been no tax avoidance purpose. He referred us to *Iliffe News and Media Ltd and others v Revenue and Customs Commissioners* [2012] UKFTT 696 (TC) in the First-tier Tribunal, where the tribunal had accepted (at para 327) his argument in that case on behalf of the taxpayer that, even on the basis that tax avoidance was one of the main purposes for which the parties were parties to loan relationships, no amount of the debits fell to be disallowed under para 13 because there was no evidence before the tribunal which enabled it on a just and reasonable basis to attribute any amount of the interest payable under the loan relationships to the tax avoidance purposes.

164. That, in our view, provides the answer to the second part of the question. It is all a question of evidence. For the purpose of the question we are asked to consider, we are required to assume that there are other facts, of an indeterminate nature, that

would be available to the tribunal. It is impossible, in our view, to say that, whatever the nature of those facts might be, the whole of the debit in the Borrower would have to be attributed to the unallowable purpose.

165. Although we accept that it would be open to HMRC to argue, as Mr Ghosh did, that the only reason for the Shares being issued to the Share Recipient was to avoid taxation in the hands of the Lender and the Share Recipient, and that the *only* purpose for the Borrower to have made the payment to the Share Recipient rather than to the Lender was to permit the Share Recipient and the Lender to escape tax, that is not something that can be assumed for the purpose of answering the second part of the question (which is predicated only on tax avoidance being one of the main purposes), and it is not something that can in any event be assessed without regard to all the relevant circumstances.

166. Furthermore, attractive as Mr Ghosh's analysis of the just and reasonable apportionment test might appear, in terms of simplicity of application, it does involve in our view a gloss on the words of para 13 itself, which talks only of a just and reasonable apportionment in order to arrive at the extent to which loan relationship debits are attributable to an unallowable purpose. That may be answered in a particular case by considering the extent to which the debit is greater than it would be but for the identified unallowable purpose, but that should not, in our view, be regarded as a substitute for the statutory test itself.

167. We conclude that, had we found, on the basis of the first part of the question, that it necessarily followed that the Borrower, and consequently the Borrower's loan relationship, had an unallowable purpose, we would not have been prepared to find on that basis alone that the entirety of the Borrower's debit should be disallowed.

Summary of conclusions

168. We can summarise our conclusions as follows:

(1) In relation to the Lender issues:

(a) it is not the correct and only application of GAAP to require the Lender to recognise interest income on the Loan, the Accounts are not incorrect, and the value of the Shares issued to the Share Recipient does not form part of the profits of the Lender under Chapter 2 of Part 4 to the Finance Act 1996; and

(b) s 786(5) ICTA did not apply so as to give rise to a charge to tax under Case VI of Schedule D on the Lender, and in any event such a charge would be precluded by s 80(5) FA 1996.

(2) In relation to the Share Recipient issue, the receipt of the Shares was taxable income of the Share Recipient under Case VI of Schedule D by reason of the source of that income being the loan agreement. We concluded that the receipt of the Shares would not have been so taxable as a reward for participation in the tax scheme.

(3) In relation to the Borrower issue, and on the basis of the limited case put in this respect, para 13, Sch 9 FA 1996 does not apply to the debtor relationship of the Borrower. Accordingly, no part of the debit on the Borrower's debtor relationship (the Loan) is prevented from being brought into account under Chapter 2 of Part 4 to the FA 1996.

Decision

169. In consequence of our conclusions:

(1) The appeal of Versteegh Limited (the Lender) is allowed.

(2) The appeal of Nestron Limited (the Borrower) is allowed.

(3) The appeals of Spritebeam Limited (the Share Recipient) and Prowting Limited (occupying the same position as the Share Recipient, but in a separate corporate group) are dismissed.

Costs

170. At the hearing it emerged that the appeals of Versteegh Limited, Nestron Limited and Spritebeam Limited had been allocated to the Standard category. Those cases had originally been directed to be related cases behind other lead cases for the purpose of rule 18 of the Tribunal Rules. When those appeals later became the lead cases, no direction was sought for a re-categorisation.

171. In these circumstances, there being no dispute that the appeals satisfied the conditions (in rule 23(4)) for allocation as Complex cases, we made a direction re-allocating each of those cases to the Complex category.

172. In view of our findings, we invite the parties to make applications in respect of costs of these appeals. Applications should be made not later than 28 days after the date of release of this decision. As any order for costs is likely to include a direction for detailed assessment, if not agreed by the parties, the tribunal dispenses with the requirement, under rule 10(3)(b), for a schedule of costs.

Application for permission to appeal

173. 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
GUY BRANNAN
TRIBUNAL JUDGES

RELEASE DATE: 6 November 2013