Appeal number: FTC/84/2013

UPPER TRIBUNAL
(TAX AND CHANCERY CHAMBER)

INCOME TAX — fixed rate notes stripped of interest coupons — whether difference between purchase price of stripped note and redemption value a "discount" within Schedule D Case III or ITTOIA s 369 — yes — whether notes "deeply discounted securities" — no — appeal dismissed

PHILIP SAVVA
ANDREW SAVVA
MARIO SAVVA
SAVVA SAVVA
KALLIOPI PERICLEOUS — **Appellants**

- and -

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

Tribunal: Hon Mr Justice Henderson
Judge Colin Bishopp

Sitting in public in London on 29 October 2014

Mr Hennessy Thompson (of Thompson & Co, Accountants) for the Appellants

Mr Michael Gibbon QC and Mr Imran Afzal (instructed by the General Counsel and Solicitor to HMRC) for the Respondents

Mr Justice Henderson and Judge Colin Bishopp:

Introduction

1. These are appeals by five members of the Savva family from a decision ("the Savva Decision") of the Tax and Chancery Chamber of the First-tier Tribunal (Sir Stephen Oliver QC and David E Williams CTA, "the FTT") released on 28 March 2013. The appeals to the Upper Tribunal are brought with permission granted by Sir Stephen Oliver QC on 9 July 2013.

2. We heard the appeals on 29 October 2014, immediately after hearing the appeal of Mr Malcolm Healey (in Case No. FTC/64/2013) from another decision of the FTT, with the same constitution, released on 7 March 2013 ("the Healey Decision"). Although the Healey Decision was released three weeks before the Savva Decision, the FTT had heard argument on the Savva appeals separately from, and about two and a half months before, Mr Healey's appeal.

3. The appeals to the Upper Tribunal of Mr Healey and the Savva family were ordered to be heard in sequence, and in that order, by the same panel of the Upper Tribunal, pursuant to directions given by Judge Bishopp on 23 September 2013.

4. The reason for joining the hearing of the appeals was that there are considerable factual and legal similarities between the two cases. Each involved a simple scheme, marketed and sold to the taxpayers by a bank in return for a substantial fee, which was designed to provide them with a higher return on their cash over a specified period than they could have obtained by placing it on a conventional short-term deposit.

5. Broadly speaking, this objective was planned to be achieved by stripping interest coupons for the requisite period from a high-grade fixed- or floating-rate bond bought in the market by the bank. The bank would then sell the bond, stripped of the relevant coupons, to the taxpayer at an appropriately discounted price; the taxpayer would hold the bond until the end of the stripped period; and the bond would then be sold on the market for its full undiscounted value. The hope was that the profit thus realised by the taxpayer would be a profit of a capital (not an income) nature, that it would not be liable to income tax (whether as a discount, or otherwise), and that it would be exempt from capital gains tax ("CGT") as a gain on the disposal of a qualifying corporate bond.

6. The schemes were marketed (by Kleinwort Benson Private Bank ("KB") in the case of Mr Healey, and by UBS Wealth Management, a financial services arm of UBS AG ("UBS"), in the case of the Savva family) in the early years of the present century, before the enactment of legislation which would on any view have charged the relevant profits to income tax. HMRC did not close their lengthy enquiries into the taxpayers' tax returns until 2011, which explains the very long delay between the transactions now in issue and the hearing by the FTT of the taxpayers' appeals (from closure notices issued by HMRC).

7. We heard Mr Healey's appeal on 27 and 28 October 2014, and the appeals of the Savva family on the following day, 29 October. The Savva family's representative, Mr Hennessy Thompson of Thompson & Co (a firm of accountants), was present in court for the hearing of Mr Healey's appeal. To a

large extent, he was content to adopt the comprehensive submissions of counsel for Mr Healey (Mr Kevin Prosser QC and Mr Charles Bradley), save in relation to the following two issues on which his clients' case diverges from Mr Healey's.

8. First, although at times he appeared to come close to it, we did not understand Mr Hennessy Thompson to concede that there was a "discount" within the meaning of Case III, paragraph (b), of Schedule D or of the legislation which replaced it in the Income Tax (Trading and Other Income) Act 2005 ("ITTOIA 2005"). Secondly, the Savva appeals give rise to a further question which does not arise in Mr Healey's case, namely whether the relevant profits were chargeable to income tax as profits on the disposal of "deeply discounted securities" within Part 4, Chapter 8, of ITTOIA 2005. References below to "Chapter 8" relate to Chapter 8 of Part 4.

9. The submissions for HMRC in both appeals were presented by Mr Michael Gibbon QC and Mr Imran Afzal.

10. We are releasing our decisions on the two appeals separately, but on the same day. Without intending any discourtesy to the Savva family, it is convenient to treat our decision on Mr Healey's appeal ("the Healey UT Decision") as the lead decision. To avoid duplication, the present decision should be read in conjunction with the Healey UT Decision, and we will refer to it as appropriate.

Facts

11. Each of the five appeals raises identical issues on materially identical facts. The appeal of Mr Andrew Savva was taken as representative by the FTT, and we will do likewise.

12. The facts are fully set out in paragraphs 4 to 17 of the Savva Decision, the neutral citation of which is [2013] UKFTT 211 (TC). As with Mr Healey's appeal, only a brief summary is necessary in order to place the "discount" issues in context.

13. The scheme was marketed by UBS under the acronym "STICS" (Sterling Investment in Capital Security). It was described as follows in a disclosure made by UBS to HMRC on 29 September 2004, under the Disclosure of Tax Avoidance Schemes ("DOTAS") – another acronym – rules which had been recently introduced by section 308 of the Finance Act 2004:

> "STICS is an investment giving UK resident individuals a tax-efficient fixed rate of return compared with holding cash or short to medium term deposits.
>
> The investment involves the following:
>
> - The Client purchases a corporate bond from UBS. The bond is issued by a financial institution with a credit rating of A+ or above;
> - The bond purchased has had its coupons removed ('stripped') and is therefore sold to the Client at a price reflecting the present value (based on current interest rates) of the future redemption value;
> - The value of the bond appreciates during the term and reaches par at maturity.

> Rather than investing in a fixed term Sterling deposit (which would generate interest income), the Client instead purchases a stripped corporate bond which gives rise to an exempt capital gain:
>
> - Because the bond has had its coupons stripped, no interest income is receivable by the Client;
> - The profit on eventual sale or maturity of the bond is a capital item for tax purposes (not income) and, as the bond is a Qualifying Corporate Bond, the capital gain is exempt from capital gains tax."

14. Two points of distinction from the product sold by KB to Mr Healey may be noted. First, the corporate bonds acquired by UBS could in principle carry either a fixed or a floating rate of interest. Secondly, all of the interest coupons falling due until maturity would be stripped before the bond was sold by UBS to the client, and the client would then hold the bond until maturity.

15. The Savva family had sold the family business, and were looking to invest the proceeds of sale: see paragraph 2 of Mr Savva's witness statement, which we mention because this fact is not recorded in the Savva Decision. A financial adviser then put them in touch with UBS. Following a presentation at a meeting on 20 September 2004, Mr Savva signed a Key Features Document confirming that he understood the risks associated with the product.

16. On 5 October 2004, Abbey National Treasury Services Plc ("ANTS") made an issue of £14.2 million fixed rate notes, due to mature on 27 January 2006, pursuant to a Euro Medium Term Note Programme which ANTS and other companies in the Abbey National group of companies had offered to the market in or around March 2004.

17. The notes issued under the programme were held in the Euroclear system. Ownership interests in the notes were represented by entries in the accounts of participants or clients of Euroclear, and legal title to the notes could only be transferred through Euroclear. As the FTT explained in paragraph 12 of the Savva Decision:

> "The practical effect of the above is that on the issue of each tranche of [*notes*] to UBS, UBS would be the custodian and all the [*notes*] would be held to their account in Euroclear. A record of which UBS client held the particular note would be maintained by UBS. UBS's customers, such as Mr Savva, did not receive certificates denoting their interests in the [*notes*]."

18. On or before 28 September 2004, Mr Savva had contracted with UBS to purchase £2.029 million nominal of the ANTS notes which were issued on 5 October 2004, for value on 19 October 2004. The ANTS notes, as issued, carried interest at a fixed rate of 4.98%, payable in arrears on 19 October 2004, 19 April 2005, 19 October 2005 and 27 January 2006 (the day of maturity). It was agreed, however, between UBS and Mr Savva that the rights to these interest payments would be stripped from the notes before they were sold to him by UBS for a discounted price. The precise date when the stripping took place is unknown, but no timing point is taken by HMRC, and it is common ground that it had occurred before beneficial title to the notes was acquired by Mr Savva.

19. The price which Mr Savva paid to UBS for the stripped notes was £1,923,068.20, representing 94.78% of their nominal value. The FTT referred to the subject-matter of that purchase as "Mr Savva's STICS". According to the Key Features Document which Mr Savva had signed on 20 September, the purchase price which he paid took into account the prevailing interest rate to maturity, the absence of coupon payments, the term to maturity, and UBS's margin.

20. On 27 January 2006, the date of maturity, the full nominal value of the notes (£2.029 million) was paid or credited by UBS to Mr Savva, who thereby made a profit on his investment of £105,913.80.

The "discount" issues

21. At the date when Mr Savva purchased the stripped ANTS notes from UBS, the charge to income tax on discounts was still contained in section 18 of the Income and Corporation Taxes Act 1988, under paragraph (b) of Case III of Schedule D. Those provisions are set out in paragraph 20 of the Healey UT Decision, and we will not repeat them. When Mr Savva realised his profit on disposal of the notes in January 2006, however, the relevant charging provisions were contained in ITTOIA 2005, as follows:

> "**369 Charge to Tax on Interest**
>
> (1) Income tax is charged on interest.
>
> (2) The following sections extend what is treated as interest for certain purposes —
>
> …
>
> section 381 (discounts).
>
> …"
>
> "**381 Discounts**
>
> (1) All discounts, other than discounts in deeply discounted securities, are treated as interest for the purposes of this Act.
>
> (2) In this section 'deeply discounted securities' means securities to which Chapter 8 of this Part applies (profits from deeply discounted securities)."

22. Neither side has suggested that the charge to income tax on "all discounts", imposed by sections 369 and 381(1) of ITTOIA 2005, differs in any material respect from the previous charge to income tax in respect of "all discounts" under Case III of Schedule D. It should be noted, however, that if Mr Savva's profit was in fact a profit on the disposal of deeply discounted securities within the meaning of Chapter 8, the latter charge would take priority. This is explicitly stated by section 367(1) of ITTOIA 2005, which says that:

> "(1) Any income, so far as it falls within Chapter 2 (interest) and Chapter 8 (profits from deeply discounted securities), is dealt with under Chapter 8."

We will therefore proceed, for the time being, on the assumption that Mr Savva's profit did *not* fall within Chapter 8.

23. Making that assumption, it is in our judgment clear both that Mr Savva's profit was a "discount" within the meaning of section 381(1) and that it was a discount of an income nature.

24. The FTT regarded the first point as so clear that no authority was needed to support it. They said at paragraph 27 of the Savva Decision:

> "The price paid to UBS by Mr Savva and the others reflected the net present value of the stripped [*notes*] and stood at a discount to maturity. The increased amount payable to Mr Savva was, on that basis (and without the need to rely on any authority), a profit on a discount taxable as income under Case III of Schedule D or section 381(1) ITTOIA. Further, to address Mr Hennessy Thompson's argument, while we agree that the [*notes*] were issued at par and redeemed at par, Mr Savva never paid more than their net present value, i.e. the discounted amount, following the stripping of the interest coupons."

We respectfully agree. If authority is needed, it may be found in *Ditchfield v Sharp* (1983) 57 TC 555 at 568-569 per Fox LJ: see the Healey UT Decision at paragraphs 42 and 54.

25. As we have said, Mr Hennessy Thompson did not formally concede the point, but it seems to us that he recognised its force when he said on page 10 of his skeleton argument that Mr Savva purchased the corpus of the relevant ANTS Eurobonds, without the coupons, "at market value i.e. at a discount to face value".

26. As to the second point, if we are right in our analysis of the law and the facts in Mr Healey's case, the same result must follow in the present case. The discount was of an income nature because, viewed from Mr Savva's perspective, its only function was to compensate him for the interest coupons which had been stripped from the notes before they were sold to him. His position was indistinguishable from that of an investor who purchases a zero-coupon bond at a discount, without the added (although in our view cosmetic) complication in Mr Healey's case of the rights to interest (represented by coupons 1 and 9 to 12) which he retained. The scheme sold to the Savva family was both simpler and starker than that sold to Mr Healey, and we have no hesitation in agreeing with the FTT that the profit realised by Mr Savva from the discounting transaction which he entered into with UBS was of an income nature.

27. In paragraph 38 of the Savva Decision, the FTT stated their conclusion on this issue as follows:

> "Our conclusion is that the 'profit' obtained by Mr Savva was within the scope of section 381 of ITTOIA, the charging provision. His purchase was for an amount discounted to maturity. There was no economic return to him other than the discount and the investment was evidently chosen because it provided a better return than the bank deposits. In our view, the transaction falls within the words 'all discounts' used in the charging provision."

While we entirely agree with the FTT's overall conclusion, we would respectfully question their apparent reliance on Mr Savva's reasons for choosing to invest in the STICS product. Characterisation of the discount as income or capital in nature depends on the purpose which the discount fulfilled in the context of Mr Savva's investment, rather than the subjective motives which induced him to choose it. The distinction may seem a fine one, but if it is not observed there is always the danger of appearing to fall into the "economic equivalence" trap: see the Healey UT Decision at paragraphs 48 to 50 and 56. To make the same point in a different way, the discount is properly characterised as being of an income nature, not because it provided Mr Savva with a better return on his money than a short-term deposit of the same amount would have done, but rather because the sole function of the discount was to compensate him for the absence of any interest on his investment over the period of approximately 16 months between his agreement to purchase it from UBS and its maturity.

The alternative head of charge: deeply discounted securities

28. We now consider the alternative basis upon which HMRC seek to charge Mr Savva's profit to income tax, namely as a profit on the disposal of deeply discounted securities. As we have explained, if this head of charge were established it would take priority over the discount head of charge: see paragraph 22 above.

29. Chapter 8 of ITTOIA 2005 runs from sections 427 to 460. Sections 427 and 428 provide as follows:

> "**427 Charge to tax on profits from deeply discounted securities**
>
> (1) Income tax is charged on profits on the disposal of deeply discounted securities.
>
> (2) The profits are treated as income for income tax purposes if they would not otherwise be income.
>
> **428 Income Charged**
>
> (1) Tax is charged under this Chapter on the full amount of profits arising in the tax year.
>
> (2) The profits on a disposal are to be taken to arise when the disposal occurs.
>
> …"

30. The definition of "deeply discounted security" is contained in section 430. We do not need to set it out in full, because it is common ground that, if it were correct to regard the stripped notes purchased by Mr Savva as a separate security in their own right distinct from the ANTS notes, it would satisfy the terms of the definition. It is enough to say that the general rule, set out in section 430(1), is that a security is a "deeply discounted security" for the purposes of Chapter 8:

> "if, as at the time it is issued, the amount payable on maturity or any other possible occasion of redemption … exceeds or may exceed the issue price by more than"

an amount which is then specified by reference to a formula.

31. Section 439 deals with calculation of the profit from a disposal. A person's profit on a disposal is the amount by which the amount payable on the disposal exceeds the amount which he paid to acquire the security, and no account is to be

taken of any incidental expenses incurred in connection with either the disposal or the acquisition: see subsections (1) and (2).

32. The questions which we therefore have to consider are:

(a) whether Mr Savva's STICS (i.e. the subject matter of his purchase from UBS) was a separate "security"; and, if so,

(b) whether it was "issued",

in each case within the meaning of those expressions in section 430(1). Neither expression is relevantly defined, whether in Chapter 8 or elsewhere in ITTOIA 2005. If, but only if, both questions are answered in the affirmative, it is then common ground that Mr Savva's profit (computed in accordance with section 439) would fall within the charge to income tax in section 427(1).

(a) Was Mr Savva's STICS a separate "security"?

33. In our view it is not commercially realistic to regard Mr Savva's STICS as a separate security. The subject matter of the sale to him by UBS was simply the £2.029 million nominal ANTS notes, from which the four interest coupons had been stripped. The underlying securities issued by ANTS on 5 October 2004 remained unchanged, although the beneficial ownership of the rights conferred by those securities had been split between the rights to capital on maturity (which were sold to Mr Savva) and the rights to interest in the meantime (which were retained by UBS). Thus what Mr Savva acquired was not a separate security, in our judgment, but beneficial title to parts of existing securities.

34. It makes no difference to this analysis, we think, that after the strip had taken place separate entries were made in the records of Euroclear for the different ownership interests of UBS and Mr Savva in the relevant notes. Nor is it significant that UBS, in the purchase note and subsequent confirmation which it sent to Mr Savva, described the subject matter of his purchase as "ANTS 0% 2004 – 27.01.2006 STICS 48(GBP)". These points reflect the division of the beneficial ownership of the notes brought about by the strip, and the fact that Mr Savva's STICS was in substance a zero-coupon investment as between himself and UBS. But the underlying ANTS notes remained exactly the same throughout. They had not been supplanted by, or transformed into, separate securities representing the rights to capital on the one hand and the individual income coupons on the other.

35. The FTT reached the opposite conclusion, finding assistance in authorities which discuss the meaning of "security" in the CGT legislation, especially in the context of that enigmatic phrase "the debt on a security" which has formed part of the CGT legislation since its earliest days: see the Savva Decision at paragraphs 42 to 47. So, for example, in *W T Ramsay Ltd v IRC* [1982] AC 300, Lord Wilberforce at 330B said that "a contractual loan, with a structure of permanence such as fitted it to be dealt in and to have a market value" was a debt on a security, with the result that a gain realised on its disposal was a chargeable gain.

36. The FTT also referred to the review of the authorities by the Court of Appeal in *Taylor Clark International Ltd v Lewis* (1998) 71 TC 226 at 256-267 per Peter Gibson LJ (with whom Schiemann and Simon Brown LJJ agreed). The Court of Appeal held, affirming the decision of Robert Walker J in the High

Court, that a loan made by a UK company to its Californian subsidiary in return for a promissory note payable on demand, with interest at a commercial rate, did not constitute a debt on a security, even though the debt was secured and the note was expressed to be assignable. As Peter Gibson LJ said, at 267A-D:

> "To my mind, the Judge was plainly right to hold that the loan was not a marketable security in any realistic sense, the most important features outweighing the others relied on by Mr Aaronson [*counsel for the taxpayer*] being the absence of any fixed term for the loan, the fact that it was repayable on demand by the holder of the note and the fact that it was repayable by Holdings at any time without penalty or additional consideration … This does not appear to me to be a loan intended to be marketable or dealt in even though it was assignable, still less does it appear to have been intended to be assigned other than as a whole. It was common ground that the promissory note could not be divided, though no doubt equity would recognise an assignment of part of the benefit of the loan. The laxity of the documentation, though I accept always curable, confirms the impression that the loan was never intended to be a marketable security but was a mere interest-bearing loan, with security, from a parent company to its subsidiary."

37. Taken in isolation, this passage might suggest that a loan with the features of Mr Savva's STICS would have a sufficient structure of permanence to constitute a debt on a security for CGT purposes. But that is not the question which we have to consider. We come back to the simple point that all Mr Savva acquired was beneficial title to the relevant ANTS notes stripped of their interest coupons. He did not thereby acquire a new security, but only certain rights in existing securities.

(b) Was there an "issue" of Mr Savva's STICS?

38. Our conclusion that Mr Savva did not acquire a separate security makes it unnecessary for us to consider whether, if he did, the security was "issued" within the meaning of section 430. The FTT held that this condition too was satisfied. After referring to the decision of the Court of Appeal in *Agricultural Mortgage Corporation Ltd v IRC* [1978] Ch 72, where the question was whether there had been an "issue" of loan capital for stamp duty purposes, the FTT found (paragraph 50 of the Savva Decision) that:

> "UBS appears to have aimed to keep to a minimum any written records of its relationship with its STICS clients."

39. Nevertheless, the FTT accepted that UBS kept internal records of the relevant trades, and concluded (in paragraph 51):

> "Something evidently falls to be done on the UBS side both to declare the beneficial interests of the clients in their STICS and to evidence the nature and extent of their interests. What was done amounted, we think, to the 'issue' to Mr Savva of his rights under the STICS. The STICS were, in our view, issued by UBS within the meaning of the deeply discounted securities legislation."

40. It is unnecessary for us to reach a conclusion on this question, and we prefer not to do so. What will amount to an "issue" of a security in a given case is likely

to be highly fact-specific, and the case law shows that it can be a very difficult question to answer. For present purposes, it is enough to say that, if the rights which Mr Savva received from UBS did constitute a separate security, we doubt whether there is any demonstrable error of law in the FTT's conclusion that the security was "issued" by UBS.

41. Since, however, we have concluded that Mr Savva did not receive a separate security, it follows that Mr Savva is not chargeable to income tax under Chapter 8 of ITTOIA 2005. Accordingly, there is nothing to displace the charge under sections 369 and 381(1), which as we have explained we consider to be well-founded.

Conclusion

42. In the result, for reasons which differ in some respects from those given by the FTT, we conclude that these appeals must be dismissed.

Hon Mr Justice Henderson

Judge Colin Bishopp

Released 25 March 2015