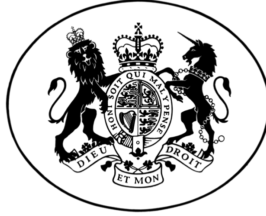

[2015] UKUT 0075 (TCC)

Appeal number FTC/14-16/2014

CORPORATION TAX — company lends money to another group company on terms that shares are paid to a different group company — is the value of the shares income of the lender under the loan relationship rules? — no, but only because of the effect of s. 80(5) of the Finance Act 1996 — is the value of the shares income of the share recipient? — yes — appeals dismissed.

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

BETWEEN

(1) SPRITEBEAM LIMITED
(2) PROWTING LIMITED
(3) THE COMMISSIONERS FOR H M REVENUE AND CUSTOMS

Appellants

and

(1) THE COMMISSIONERS FOR H M REVENUE AND CUSTOMS
(2) VERSTEEGH LIMITED

Respondents

TRIBUNAL: MRS JUSTICE PROUDMAN DBE
JUDGE COLIN BISHOPP

Sitting in public at The Rolls Building, Fetter Lane, London EC4A 1NL on 6 and 7 October 2014

Kevin Prosser QC and James Henderson, instructed by PricewaterhouseCoopers Legal LLP for the first two appellants and the second respondent

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

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DECISION

Background

1. These appeals are lead cases concerning a corporation tax avoidance scheme. The scheme was simple in its structure: one company in a group ("the Lender") lent money to another group company ("the Borrower") under a loan agreement ("the Loan Agreement") on terms that although the capital was repayable to the Lender no interest was payable while the loan was outstanding but instead irredeemable preference shares (equal in value to a commercial rate of interest on the loan) were to be issued to a different group company ("the Share Recipient"). The Lender and the Share Recipient maintain that neither of them is liable for tax on the interest, on a sum equivalent to it or on the value of the shares, and neither entered a taxable credit on its corporation tax return. The Borrower sought a corporation tax deduction for the interest in the form of the value of the shares. Its corporation tax position, however, is not in issue on this appeal.

2. The First-tier Tribunal ("the FTT", Judges Berner and Brannan) found partly in favour of HMRC and partly in favour of the taxpayers, by finding: (i) that the Share Recipient was taxable on the interest in the form of shares, or alternatively, on the value of the shares as an amount analogous to interest, under Schedule D Case VI as defined in s. 18 of the Income and Corporation Taxes Act 1988 ("ICTA"); and (ii) that the Lender was not taxable under s. 786(5) of ICTA on an amount equal to the interest. The Share Recipients and HMRC each appeal to this Tribunal against the part of the decision that was determined against them.

3. The various statutory provisions to which we refer are those which applied to the transactions at the relevant time (2003). They have since been repealed and replaced but without retrospective effect. Unless otherwise stated, the extracts from the legislation set out below reproduce it as it was then in force.

4. Two iterations of the scheme were considered by the FTT, since it was initially thought that there might be a relevant difference of fact between them, but it is now common ground that there was not so that no distinction of terminology needs to be made between the various companies. In the first appeal (the facts of which we, like the FTT, have taken as representative of both), Versteegh Group was the Lender, Nestron Limited was the Borrower and Spritebeam Limited was the Share Recipient. In the second appeal, Westbury Limited was the Lender, Westbury Homes was the Borrower and Prowting Limited was the Share Recipient. It is common ground that the companies in each iteration were "connected persons" as that term is defined by s. 839 of ICTA.

5. There were four issues before the FTT, as follows:

(i) Whether the value of the shares fell to be brought into account by the Lender under the loan relationship rules contained in Chapter 2 of Part 4 of the Finance Act 1996 ("FA 1996"). The FTT held that it did not because UK GAAP (agreed to be the applicable authorised accounting method) requires the Lender not to recognise the value of the shares so that s. 84 of FA 1996 requires the value of the shares to be left out of

account for the purposes of the loan relationship rules. HMRC do not appeal that finding.

(ii) Whether the value of the shares was income of the Lender under s. 786(5) of ICTA. The FTT held it was not and that finding is the subject of HMRC's appeal.

(iii) Whether paragraph 13 of Sch 9 to FA 1996 (entitled "loan relationships for unallowable purposes") prevents the Borrower from bringing any debit into account in respect of the loan. The FTT again held that it does not, and HMRC do not appeal that finding.

(iv) If the answers to (i) and (ii) above were negative, as they were, whether the value of the shares was income of the Share Recipient under Case VI of Schedule D. The FTT held that it was and that is the issue in relation to which the Share Recipients are the appellants.

6. Agreed facts are set out in [8] of the FTT's decision. Additional undisputed findings of fact are set out in [103]. Those relevant now can be summarised quite shortly. In each case the Lender was the parent of the Borrower and the Share Recipient, all three of which were UK-resident companies with common directors. There was a commercial need for the loan, but the only purpose of adopting the structure we have described was to obtain a tax advantage for the Lender or the Share Recipient. The critical clause in the Loan Agreement, dated 7 April 2003, provided:

> "The consideration to be given by the Borrower in respect of the Loan shall be the repayment of the principal amount of the Loan and the allotment and issue to [the Share Recipient], a wholly owned subsidiary of the Lender, at the end of the Term, such number of shares as have, in aggregate, a market value calculated in accordance with [there is then a cross reference to the formula contained in another clause]."

7. The formula was designed to ensure that the value of the shares issued to the Share Recipient was equivalent to the interest which would have accrued, at a market rate, over the term of the loan; as the clause indicates, the shares were issued on redemption of the loan. The Share Recipient was not a party to the Loan Agreement and gave no consideration for the shares, which were issued fully paid up and carried no onerous obligations. The Loan Agreement excluded the application of the Contracts (Rights of Third Parties) Act 1999, and the Share Recipient therefore could not enforce any contractual rights under it, but it knew (by virtue of the fact that the companies were in common ownership and control) that the arrangements were structured as we have described them.

8. The issues before this Tribunal are:

(a) "*The Lender Issue*". The first limb of this issue is the construction of s. 786 of ICTA. The second limb is whether the application of s. 786 is precluded by s. 80(1) and (5) of FA 1996.

(b) "*The Share Recipient Issue*". It is common ground that as the Share Recipient was not a party to the Loan Agreement the loan relationship provisions of FA 1996 do not apply to it. The single issue under appeal is whether the value of the shares was income in its hands under Schedule D Case VI.

9. HMRC, represented before us by Mr Julian Ghosh QC leading Ms Barbara Belgrano, said that their primary position was that the value of the shares was income of the Lender under s. 786 of ICTA and that the FTT was wrong to conclude otherwise; they did not press the argument that the arrangements led to a double tax charge even though that would be the result if the FTT's conclusion that the Share Recipient was taxable under Case VI was right. As one might expect the taxpayers, represented by Mr Kevin Prosser QC leading Mr James Henderson, support the FTT's conclusion on the Lender Issue but attack its finding on the Share Recipient Issue. They argue, in essence, that the issue of the shares escapes any charge to tax.

The Lender Issue: (a) Construction of s. 786 of ICTA

10. Section 786 was to be found in Part XVII of ICTA, entitled "Tax Avoidance", which contained numerous provisions designed, or apparently designed, to counter a considerable number of disparate avoidance arrangements. So far as material, s. 786 (entitled "Transactions associated with loans or credit") provided as follows:

> "(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.
>
> (3) If the transaction provides for the payment of any annuity or other annual payment, not being interest, being a payment chargeable to tax under Case III of Schedule D, the payment shall be treated for all the purposes of the Tax Acts as if it were a payment of annual interest.
>
> [(4) If the transaction is one by which the owner of any securities or other property carrying a right to income ('the owner') agrees to sell or transfer the property ('the relevant property'), and by the same or any collateral agreement—
>
> (a) the purchaser or transferee ('the buyer'), or a person connected with him, agrees that at a later date he will sell or transfer the same or any other property to the owner or a person connected with him; or
>
> (b) the owner or a person connected with him acquires an option which he subsequently exercises, to buy or acquire the same or any other property from the buyer or a person connected with the buyer;
>
> then, without prejudice to the liability of any other person, the owner shall be chargeable to tax under Case VI of Schedule D on an amount equal to any income which arises from the relevant property at any time before the repayment of the loan or the termination of the credit.]
>
> (5) If under the transaction a person assigns, surrenders or otherwise agrees to waive or forego 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 foregone.

(6) If credit is given for the purchase price of any property, and the rights attaching to the property are such that, during the subsistence of the debt, the purchaser's rights to income from the property are suspended or restricted, he shall be treated for the purposes of subsection (5) above as if he had surrendered a right to income of an amount equivalent to the income which he has in effect foregone by obtaining the credit."

11. We have put sub-s. (4) in square brackets because at the relevant time it had been repealed by FA 1996. As it was the subject of one of the taxpayers' submissions on the construction of sub-s. (5), on the basis that sub-s. 5 could not change its meaning when sub-s. (4) was repealed, we have however included it.

12. HMRC say that according to its ordinary meaning s. 786(5) renders the income assessable on the Lender (again, in accordance with Case VI). The transactions were effected "with reference to the lending of money or the giving of credit" and so fell within the scope of s. 786 by virtue of sub-s. (1). Subsection (2) was also satisfied because the various companies were connected. The shares represented income arising from the property (the Loan); that the Lender chose to require the Borrower to issue shares rather than pay interest in the form of cash did not convert the income the Lender was entitled to receive into something else. Subsection (5) was engaged because a direction that the income be paid (or, in this case, that the shares representing or constituting that income be issued) to a third party other than the Lender represented a "waiver" or "foregoing" of that income.

13. This argument depends for its validity, at least in part, on whether Mr Ghosh is right to say that the transactions were of the kind described in s. 786(1), and that the section is engaged. The FTT decided that they were not, putting its reasoning in this way:

"[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, foregone.

[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 foregoing 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 foregoing 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 [*sic*] any right, actual or putative, to any income under the Loan. There was nothing for the Lender to forego under the transaction of the issue of the Shares to the Share Recipient."

14. Mr Prosser supported that reasoning and the conclusion at which the FTT arrived. The issue of the shares was a requirement of the Loan Agreement itself rather than one imposed by a separate transaction. The operative subsections of s. 786 looked to separate transactions: annuities, transfers of property, assignments or surrenders of income from property and similar arrangements. Thus the FTT's conclusion was consistent with the structure of the section.

15. Mr Ghosh pressed upon us the plain text of subsection (1). However in the event that this tribunal were to find that the FTT was correct, he submitted that the consideration clause in the Loan Agreement obliging the Borrower to issue and allot the shares to the Share Recipient could be regarded as sufficiently separate to the loan of the principal itself.

16. In this regard we do not agree with the FTT. We do not consider that the phrase: "… any transaction effected with reference to the lending of money or the giving of credit…" requires the transaction to be something separate from the loan or credit arrangements themselves. It seems to us that this is the plain meaning of the section. Section 786(1) is worded as it is in order to catch any arrangement for the lending of money however that arrangement may be constructed. We find nothing in its wording which could be read as limiting its application to collateral transactions, and do not agree that the subsection requires the existence of both the loan and a separate transaction if the operative provisions of the section are to be engaged. Indeed, the repealed sub-s. (4) expressly stated that it applied whether the relevant arrangements were implemented by one document or several.

17. A requirement for a separate arrangement puts form over substance. Mr Prosser argued, as we shall explain, that the mischief at which the subsection is aimed is the use of transactions designed to circumvent restrictions on tax relief for the payment of interest. If he is right about that, the taxpayer could incorporate an annual payment or the transfer of income-bearing property in lieu of interest into the loan agreement itself rather than by way of separate documentation, and thus escape s. 786(1). The construction that this tribunal adopts is consistent with the nature of s. 786 as an anti-avoidance provision.

18. The form over substance point was put to Mr Prosser during the course of argument. He suggested that there might be degrees of separation: a schedule to a loan agreement containing a deed that effected an annual payment might be sufficiently separate, but the consideration clause was not sufficiently separate. Such a distinction is ultimately untenable and in any event allows parties to structure transactions so as easily to bypass the anti-avoidance provisions.

19. Mr Prosser accepted that, if it is engaged, s. 786 can have a very wide meaning on a purely literal reading. However, he pointed out, s. 786 has nothing to say about the taxpayer's purpose or any expected tax benefit. It targets, and applies only to, transactions which would, but for the section, circumvent

restrictions on tax relief for the payment of interest on a loan or other credit. Thus a purposive construction should be adopted to narrow the scope of the section to those transactions, and only those transactions, which might circumvent such restrictions. This was not such a case since (as we have explained at para [5](iii) above) it was no longer asserted by HMRC that the restriction imposed by para 13 of Sch 9 to FA 1996 applied to the Borrower.

20. Mr Prosser pointed to s. 786(3) which targeted transactions where the borrower paid to the Lender an annuity or other annual payments economically equivalent to interest. Such an arrangement would be analogous to that adopted in *IRC v. Duke of Westminster* [1936] AC 1—the Duke paid his gardener an annuity in lieu of wages in order to try to obtain relief for the payments against his own income tax liability. Again, the repealed s. 786(4) targeted transactions where the borrower tried to obtain favourable tax treatment by transferring income-producing property on terms that the property would be transferred back in the future; the income received by the purchaser in the interim was economically equivalent to interest. Yet again, s. 786(6) caught transactions where the borrower relinquished income otherwise due from property purchased on credit in a manner which, similarly, provided the lender with the economic equivalent of interest on a loan.

21. Thus he argued that (a) in all these subsections the person obtaining the tax advantage is the borrower or debtor and (b) all these subsections prevented the circumvention of interest relief restrictions. Similarly s. 786(5) caught transactions where the borrower assigned the right to income from property without transferring the property itself and also caught transactions where the borrower agreed to waive or forego income arising from property. The concern was only to cover transactions comprising transfers of income which were economically equivalent to interest.

22. In this regard Mr Prosser pointed to the legislative history of s. 786. It had first appeared as paragraph 12 of Sch 13 to the Finance Act 1969 ("FA 1969"). Schedule 13 was expressed to be "a supplement" to sections 18 to 27 of FA 1969 which, while giving relief for specific cases, prevented a general deduction from income. Paragraph 12 was entitled "Tax avoidance: transactions associated with loan or credit", and although the words "Tax avoidance" do not appear as a heading to s. 786, that section is contained, as we have said, in ICTA Part XVII which is so entitled. Consolidation could not be intended to alter the ambit or meaning of the consolidated provisions.

23. Mr Prosser also referred us to HMRC's answer to a question from the Institute of Chartered Accountants in England and Wales ("ICAEW") reproduced in *Simon's Tax Intelligence* (1993) at pp 1333-4. The question asked for confirmation that s. 786(5) did not apply other than in income tax avoidance situations. The reply was as follows:

> "…S. 786(5) was introduced to tackle schemes of income tax avoidance - specifically, at attempts to circumvent the restrictions on personal tax relief for interest by a debtor substituting other income foregone for interest otherwise payable. We continue to regard the subsection as aimed at situations involving tax avoidance. Although we cannot rule out in principle its potential application to cases involving corporation tax rather than income tax, we would in practice expect this to be exceptional given the

> relatively less restricted relief available for interest expense of companies. We would not expect to invoke the provision in the sort of case cited by the Institute – bona fide reorganisations and straightforward refinancing of insolvent companies."

24. Mr Prosser relied on what Lord Bridge said in *Wicks v. Firth* [1983] 2 AC 214 at p 231:

> "This is not a decisive consideration, but in choosing between competing constructions of a taxing provision it is legitimate, I think, to incline against a construction which the revenue are unwilling to apply in its full rigour, but feel they must mitigate by way of extra-statutory concession, recognising, presumably, that in some cases their construction would operate to produce a result which Parliament can hardly have intended."

25. A literal reading of s. 786 would produce just such a result, he said, and would only reflect current practice if supplemented by extra-statutory concession, to deal for example with the case of a person who had decided to forego interest on a loan for commercial reasons such as a restructuring.

26. However HMRC's comments cannot change the clear words of s. 786, and we agree with the FTT that the arrangements appear to fall within s. 786(5) (although as we have said we disagree with the FTT's view that sub-s. (1) precluded the application of sub-s. (5)). We also agree with the observation of the FTT, at [82], that the scope of s. 786 cannot be restricted by the mischief at which the provisions seem to have been aimed when no such restriction can be read into the words used. The right to repayment of the principal was the Lender's property and, as the consideration clause of the Loan Agreement makes clear, the value of the shares was income arising from that property in the form of interest. Moreover, extra statutory concessions have become an unremarkable part of the UK taxation regime and do not indicate that something has gone wrong with a particular part of a tax statute.

27. We note too that HMRC's answer to the ICAEW's question is not in any event wholly supportive of Mr Prosser's analysis. It demonstrates that s. 786(5) has the potential to be applied to circumstances outside the apparent mischief.

28. In our view Lord Bridge's comments in *Wicks* may be distinguished. Lord Bridge was already (at pp 229-230) leaning towards an interpretation based on the natural meaning of the provision before him without any straining of language. Mr Prosser on the other hand invited this tribunal to move away from such a natural meaning.

29. What therefore is the meaning of the phrase "assigns, surrenders or otherwise agrees to waive or forego"? Mr Prosser argued that one could not forego something which one did not have a right to receive. Mr Ghosh on the other hand drew a distinction (which he did not make before the FTT or in his written submissions) between the word "waived", which he said was relevant where the Lender had the right to income, and "forego", where the Lender never had such a right because the Loan Agreement itself provided that the shares would be issued and allotted to the Share Recipient. Be that as it may, we consider that the scheme falls squarely within the sense of the overall phrase. The Lender could have required that the shares be issued to him but instead chose to nominate the

Share Recipient. In our judgment that is precisely the kind of arrangement the draftsman had in mind.

30. Accordingly, we consider, contrary to the overall conclusion of the FTT on what we have described as the first limb of the Lender Issue, that the value of the shares did amount to income of the Lender under s. 786(5), subject only to the point under s. 80 FA 1996, to which we now turn.

The Lender Issue: (b) S. 80 FA 1996

31. The answer to this limb of the Lender Issue depends on the interpretation of the relevant parts of the loan relationships rules, which were set out in Part IV Chapter II (ss. 80 to 105) of FA 1996. Section 80(1) and (5) provided:

> "80.— Taxation of loan relationships.
>
> (1) For the purposes of corporation tax all profits and gains arising to a company from its loan relationships shall be chargeable to tax as income in accordance with this Chapter.
>
> …
>
> (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."

32. A "loan relationship" was defined by s. 81(1):

> "Subject to the following provisions of this section, a company has a loan relationship for the purposes of the Corporation Tax Acts wherever—
>
> > (a) the company stands (whether by reference to a security or otherwise) in the position of a creditor or debtor as respects any money debt; and
> >
> > (b) that debt is one arising from a transaction for the lending of money;
>
> and references to a loan relationship and to a company's being a party to a loan relationship shall be construed accordingly."

33. It is undisputed that there was a loan relationship between the Lender and the Borrower but, as we have recorded, none between either of them and the Share Recipient.

34. Section 84 reads, so far as is relevant:

> "84.— Debits and credits brought into account.
>
> (1) The credits and debits to be brought into account in the case of any company in respect of its loan relationships shall be the sums which, in accordance with an authorised accounting method and when taken together, fairly represent, for the accounting period in question—
>
> > (a) all profits, gains and losses of the company, including those of a capital nature, which (disregarding interest and any charges or expenses) arise to the company from its loan relationships and related transactions; and

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

…

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

35. The question for this tribunal is whether s. 80(5), read with s. 84, reserved lender taxation issues arising from the value of the shares exclusively to the loan relationships rules, and in so doing excluded the application of s. 786(5).

36. The first issue is whether s. 786 constitutes an "express provision to the contrary" within s. 80(5) for, if there is such an express provision, the words after the comma in s. 80(5) are simply not engaged.

37. There is an argument that s. 786(5) is an express provision to the contrary and is not overridden by s. 80(5). There are at least two other interpretations of this phrase:

- It is limited to other provisions which exclude s. 80 by their terms, for example, the now repealed s. 811(3) ICTA ("notwithstanding anything in section 80(5) of the Finance Act 1996").
- It is limited to provisions within the loan relationship rules themselves that contradict s. 80(5).

38. However, our understanding is that it was conceded by HMRC before the FTT that s. 786 does not constitute an "express provision to the contrary" within the meaning of s. 80(5). Paragraph [93] of the FTT decision reads:

> "…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."

39. The matter was not raised during the hearing; Mr Ghosh did not seek to challenge what the FTT said about it and Mr Prosser's skeleton argument indicates that the matter was not in dispute. The concession was thus made and not sought to be withdrawn and we say no more about it.

40. On the basis that s. 80(5) did apply, the general rule under s. 84 also applied, namely that the credits and debits to be brought into account in respect of the Lender's loan relationships were to be the sums which, in accordance with an authorised accounting method such as GAAP, and subject to Schedule 9 of FA 1996, fairly represented all its profits, gains, losses, interest, charges and expenses. In other words, tax follows the accounting method.

41. HMRC have not appealed the FTT's decision at [58] and [60]. Thus under the accounting rules the value of the shares do not amount to income of the Lender.

42. Both the Chapter and the Schedules are otherwise silent on the issue of valuing a Lender's foregone income. Mr Ghosh submitted that this silence meant

that the loan relationship rules did not apply. Section 80(5) refers to matters being brought into account by the Chapter but the foregoing of income by the Lender is a matter nowhere dealt with by the Chapter or Schedule 9. Thus, argued Mr Ghosh, s. 80 only excluded other taxation provisions where the Chapter or Schedule 9 had something positive to say on the matter.

43. Mr Prosser riposted that where the loan relationship rules were silent, the general rule under s. 84 applied so that the (unchallenged) finding of the FTT regarding GAAP treatment meant that the value of the shares did not constitute income of the Lender.

44. He relied on the observations of Moses LJ in *DCC Holdings v. HMRC* [2009] EWCA 1165 to the effect that the loan relationship rules are:

> "…a discrete and exclusive code for the taxation of all of the profits and gains of a company arising from its loan relationships."

45. On this matter we agree with Mr Prosser and the FTT, which decided (at [98]) that, even were the value of the shares income of the Lender under s. 786(5) (as we have found), a charge would be precluded by s. 80(5). The default rule in s. 84(1) applies. This is consistent with Moses LJ's analysis in *DCC*, and no other view accounts for the existence of the "exclusivity rule" (to use Mr Prosser's terminology) contained in s. 80(5).

46. We would simply repeat the FTT's decision at [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 foregoing 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."

47. However Mr Ghosh raised two other arguments. First, he said that the loan relationship rules were only concerned with profits and losses arising from a company's loan relationships. In the present case, the value of the shares was not brought into account because the Lender had foregone the interest such that it could not amount to a profit for the Lender under its loan relationship with the Borrower. The foregoing of income was accordingly he submitted outside the scope of the loan relationship rules.

48. We find Mr Ghosh's submission about the scope of the loan relationship rules also to be too narrow. Section 84(1) of FA 1996 specifically brings into account not just profits and losses but also (see s. 84(1)(b)) "all interest under the

company's loan relationships". The value of the shares constituted such interest. Mr Ghosh himself relied in his skeleton argument on Megarry J's observations in *Re Euro Hotel (Belgravia) Limited* [1975] STC 682 at 691:

> "I do not see why payments should not be 'interest of money' if A lends to B and stipulates that the interest should be paid not to him but X."

49. Secondly, Mr Ghosh also submitted that s. 786(5) deemed the Lender to have income and that such deemed income was not excluded by s. 80(5). However, because the income under s. 786(5) was equivalent to the amount of interest foregone by the Lender, the effect would be that the amount of interest would be brought into account contrary to the exclusivity rule in s. 80(5).

50. Accordingly, we find (for rather different reasons from those of the FTT) that the value of the shares did not amount to income of the Lender. We therefore turn to the second issue, the subject of the Share Recipients' appeal, whether the value of the shares constituted income of the Share Recipient under Case VI of Schedule D.

The Share Recipient Issue

51. The scope of Schedule D was defined by s. 18(1) of ICTA 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."

52. Subsection (2) provided that tax under Schedule D was to be charged by reference to the six Cases set out in sub-s (3), which were Case I (trading income), Case II (income from professions or vocations), Case III (interest, annuities, other annual payments and discounts), Case IV (income from overseas securities), Case V (income from other overseas possessions) and Case VI:

> "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, pensions income or social security income."

53. It is common ground that the shares, or their value, cannot fall within any other Case of Schedule D (or within any other Schedule) and that it is only if they fall within Case VI that they are taxable in the Share Recipient's hands.

54. Mr Prosser's primary argument was that it is not enough that a person receives something for tax to be chargeable. That argument, as we see it, breaks down into four elements: (i) the receipt must have the character of income (a word we use as an umbrella term to include the profits or gains to which Case VI refers); (ii) it must be the recipient's income; (iii) it must have a source; and (iv) there must be a sufficient link between the source and the recipient. Mr Ghosh did not dispute those propositions as propositions; the substance of the disagreement between the parties centres on elements (ii) and (iv) as we have identified them.

55. For completeness we should mention that in *National Provident Institution v. Brown* (1921) 8 TC 57 the House of Lords left open the question whether it is necessary to identify a source before a Case VI liability can arise. Mr Ghosh sought to reserve HMRC's position on that point, saying that the question was academic in this case as there was an identifiable source. We did not, therefore, hear argument on the point and have assumed that Mr Prosser is right to contend that a source must be identified.

56. As to (i), we do not believe that this was seriously in dispute. The value of the shares was consideration for the use of the money and therefore was income. The payment of interest to the Share Recipient rather than the Lender does not change the nature of the payment: as Megarry J said in *Re Euro Hotel*, a payment is interest of money if A lends to B and stipulates that the interest should be paid not to him but to X.

57. We were referred, in respect of element (ii), to *Watkins v. Commissioners of Inland Revenue* [1939] 2 KB 420, in which a husband had given an undertaking to the court to make up a shortfall in the income of his mentally-ill wife in order that the fees of a mental institution in which she resided could be met. He sought a tax deduction for the payments, conceding in the High Court that they were not voluntary. Lawrence J said (at 424-5):

> "the crucial question … is: does the payment to be made by the husband in the present case constitute income in the wife's hands?
>
> … the wife, although she has the benefit of the expenditure, is not entitled to the money as such. She does not choose the institution and has no say in the application of the money.
>
> These considerations lead me to the conclusion that the sum payable by the husband is an expenditure of his income and does not constitute the income of the wife."

58. Thus while the wife indirectly benefited from the husband's expenditure she did not in substance receive the money in such a manner that it could be regarded as her income. Mr Prosser's argument was that the Share Recipient was in a similar position to the wife in that neither had a right to receive the payment, even though there was an obligation on the Borrower, or the husband in that case, to pay. The exclusion by the Loan Agreement of the application of the Contracts (Rights of Third Parties) Act 1999 meant that the Share Recipient had no means of enforcing payment, or in this case the issue of the shares; they amounted to a

gift in its hands. There was an analogy between this case and *Stedeford v. Beloe* [1932] AC 388, in which a pension was granted purely voluntarily to the headmaster of Bradfield College on his retirement. The question, answered in the negative, was whether the pension was income in the hands of the headmaster. Viscount Dunedin said (at 390):

> "Now it must be a real profit under Schedule D, and it has been held again and again that a mere voluntary gift is not such a profit because it is not, in the true sense of the word, income. It is merely a casual payment which depends upon somebody else's good will."

59. And Lord Warrington assented (at 391) where he said,

> "This question can, in my opinion, be answered in only one way. Here each payment is wholly voluntary. The case is only an instance of a succession of voluntary payments, each of which is voluntary and none of which need necessarily be continued."

60. Mr Ghosh, however, referred us to cases in which a purely voluntary and also non-enforceable payment was still regarded as taxable income, such as *Calvert (Inspector of Taxes) v. Wainwright* [1947] KB 526 (tip to a taxi driver) and *IRC v. Falkirk Ice Rink* [1975] STC 434 (voluntary contribution to trading profits to keep the taxpayer's ice rink open for curling). Mr Prosser's riposte, in respect of these authorities, was that the payments had been made and received in the context of the taxpayer's trade, and the absence of the legal right to enforce them was irrelevant.

61. In *Drummond v. Collins (Inspector of Taxes)* [1915] AC 1011 there was a discretionary trust of which the beneficiaries were a class of the testator's grandchildren. The trustees made payments to the children's mother and the question was whether the payments were taxable in her hands. It was argued unsuccessfully that they were merely voluntary payments. The beneficiaries had the right to require the trustees to consider the exercise of the discretion but they did not have the right to require the trustees to exercise that discretion in their favour, nor did they have anything more than a contingent right to a share in the capital of the fund. Yet that limited right was enough of an interest in the trust fund to render the payments the taxable income of the recipient.

62. Mr Prosser would say that this does not detract from his test. When the payment was made to the mother the right arose because at that moment it became non-discretionary (the discretion was exercised in favour of a relevant child) and was impressed with a trust in the children's favour. Thus at that moment they became legal and enforceable rights.

63. It does not seem to us that there has to be an enforceable legal right in the recipient to receive a payment before it can form part of his income. It is true that in *Drummond* the beneficiaries did have an enforceable right. However the members of the House of Lords did not express themselves in those terms. Indeed Earl Loreburn put it in this way (at p 539):

> "I do not assent to the proposition that a voluntary payment can never be charged, but it is enough to say that these were not voluntary payments in any relevant sense. They were payments made in fulfilment of a testamentary disposition for the benefit of the children in the exercise of a discretion conferred by the will. They were the children's income, in fact."

64. Lord Parker, too, spoke in the language of interests and entitlements rather than enforceable legal rights. The word entitlement can be limited to the right to receive rather than the right to enforce payment. In Lord Parker's view it did not matter that the mother was not a beneficiary and could not control the property, although control is often the badge of enforceability of a legal right.

65. Both *Drummond* and *Stedeford* were referred to in *Lindus & Hortin v. IRC* (1933) 17 TC 442, where it was contended that payments of capital to a beneficiary under a will (the testator's daughter) were to be regarded as voluntary payments. However, Finlay J appeared to have no difficulty in holding that such a payment was taxable as income in the hands of the daughter. We do not, however, find this case very helpful in relation to the questions we have to decide.

66. The court revisited the matter in *Cunard's Trustee v. IRC* (1945) 27 TC 122. In that case there was again under the terms of a will power to supplement income with capital to ensure the comfort and maintenance of the beneficiary. The Court of Appeal held that the payments were income of the recipient. Lord Greene MR said at 132:

> "…[her] title to the income arose when the trustees exercised their discretion in her favour and not before. At that moment a new source of income came into existence."

67. At first blush, therefore, this passage supports Mr Prosser's requirement that the taxpayer must have an enforceable right to the property. However, Lord Greene went on to say (at 133-4):

> "It was suggested, however, that the Rule does not extend to mere voluntary payments. But the payments here were of a totally different character. They 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. It is true, of course, that the trustees had an absolute discretion whether to make a payment or not. But the question whether they should do so is one which they were bound to take into their consideration. They could not refuse to consider whether the income of the estate was sufficient to give [the beneficiary] the required degree of comfort and the fact that, after examining that matter, they might come to the conclusion that it was sufficient, does not, in my opinion, give to a payment, if and when made, the character of a voluntary payment in any relevant sense."

68. The conclusion we draw from the authorities to which we have referred is that it is immaterial that the recipient cannot enforce payment; what matters is whether there is an obligation on the payer to pay. Thus in *Stedeford* there was no obligation on the governors to make any payment; they could have refrained at any time from making further payments, and neither the former headmaster nor anyone else could have compelled them to continue. By contrast, in the trustee cases the beneficiaries, individually, could not enforce the payment of any particular sum to themselves; but the trustees were under an enforceable obligation to exercise their discretion and make a payment to one or more of the beneficiaries as circumstances required. In *Drummond*, for example, the payments were not voluntary payments in any relevant sense because the payments were made on the basis of the trustees' duties arising under the testamentary trust. In the present case, the right to payment may not have been enforceable by the Share Recipient but it was not voluntary either; the Borrower was under a contractual

duty to the Lender to allot and issue shares to the Share Recipient. Thus we conclude, in relation to issue (ii), that the shares were income in the Share Recipient's hands.

69. We did not understand Mr Prosser to argue that the obligation imposed on the Borrower to issue the shares did not represent a source—or, put another way, that the source of the income was not the time value of the money lent by the Lender. Thus there is no difference between the parties about issue (iii), as we have identified it above. Mr Prosser's point, rather, was that there was no, or no sufficient, link between that source and the Share Recipient. At first sight this seems to be the argument about the distinction to be drawn between voluntary and non-voluntary payments put in another way, but on closer analysis it can be seen that it is not.

70. Mr Prosser began with a submission that a source is limited to a kind of property or a kind of activity. He relied on Schreiner JA's summary at 16 in *CIR v. Lever Bros & Unilever Limited* [1946] 13 SATC 1:

> "…a source of income is either (a) some personal activity of the taxpayer, or (b) some property over which he has rights, or (c) a combination of both."

71. He referred too to the observation of Viscount Haldane in *National Provident Institution v. Brown* at p 84:

> "There was imposed under the Schedules no collection of taxes distinct from each other, but simply one tax [income tax] with standards for assessment which varied according to the sources from which the taxable income was derived. [The Income Tax Act 1853] … was an Act to impose income tax on annual profits or gains arising from property or from some occupation."

72. Mr Prosser pointed to the Schedules themselves in support of his argument. Thus Schedule A is concerned with property (land), Schedule C property (government securities) and Schedule F property (distributions from shares). Schedule E is concerned with an activity (emoluments). Schedule D sweeps up all other matters but its contents are similarly categorised, as we have indicated at para 52 above. Case VI, as the text indicates, covers annual profits or gains not included elsewhere but we cannot think of a source that could not be categorised as either property or activity.

73. Mr Prosser submitted that the property-activity categorisation determined the necessary connection between the taxpayer and the source. If an activity then the taxpayer must carry it on, and if property, then the taxpayer must have the legal right to enforce it. A person cannot acquire legal rights under a contract to which he is not a party (see Chitty on Contracts 31st Edition (2013) at [18-021], Halsbury's Laws of England 5th Edition (2012) Vol 22 [327], the Law Commission Report on Privity of Contract: Contracts for the Benefit of Third Parties (1996) [2.1]) save under a contract to which the Contracts (Rights of Third Parties) Act 1999 applies and in this case that Act was specifically excluded. Much of the argument under this head revolved around the fact that the Share Recipient had no right to compel enforcement.

74. Many of the statutory provisions and authorities use the language of possession, for example ICTA s. 22, s. 67, s. 477, s. 480 and s. 584. In *Pumahaven v. Williams* [2002] STC 1423 at [19] and [20] Park J said:

"[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."

75. Other provisions, for example, ICTA s. 66, s. 67, s. 328, s. 477 and s. 480, use similar expressions, as do the judges in cases such as *Fitzgerald v. IRC* (1919) 7 TC 284 at 287 and *National Provident Institution* at 73 and 75: "acquiring", "having", "existing in the hands of" and "parting with".

76. Mr Prosser uses this language as a justification for the requirement that there be an enforceable right in respect of the income-bearing property such that "tax is only charged only so long as a taxpayer possesses a source of income": *Revenue Law: Principles and Practice* 31st (2013) edition (Natalie Lee) at 142.

77. The judgments in the Court of Appeal and House of Lords in *National Provident* use a different label, namely that the source must be in existence. For example, Lord Sterndale MR (at 73) said that a taxpayer could not be taxed "in respect of a source of income which does not exist", and in *Bray (Inspector of Taxes) v. Best* (1989) 61 TC 705 at 749, Lord Oliver said:

"It is a well-established principle deriving from the nature of the income tax as an annual tax, that a receipt or entitlement arising in the year of assessment is not chargeable to tax unless there exists during that year a source from which it arises."

78. In *Property Company v. IRC* [2005] STC (SCD) 59 the Special Commissioners considered the situation where an individual not domiciled in the UK and taxable on the remittance basis sold shares in a non-resident company and remitted dividends previously received in the following tax year. They said (at [89]):

"…such income is not taxable because the individual did not possess the source in the year in which it was remitted."

79. Park J, at [20] in *Pumahaven* (quoted above) expressed the rule in similar terms.

80. However this is no more than saying that if a taxpayer's connection with the source ceases, he can no longer be taxed on receipts from that source, irrespective of a different connection with the source. Similarly, we regard Mr Prosser's argument from the situation where the taxpayer has never possessed the source as merely a logical extension of the rule that a taxpayer cannot be taxed on receipts when he no longer possesses the source. When rephrased to remove the language of possession, no extension is appropriate or necessary. The rule is merely that the taxpayer cannot be taxed on receipts if he does not have the necessary connection with the source. Once the connection has been identified, it is necessary to look

behind the receipts in the tax year in question to see if the source of income continues or has ceased. But that necessity says nothing about the nature of the connection which must be demonstrated.

81. Mr Ghosh's argument was that it was the Share Recipient's status as a counterparty to an absolute obligation of the Borrower to pay interest on the Loan (an obligation satisfied by the issue of the shares) that is relevant. The validity of that contention was demonstrated, he said, by a comparison between *Drummond v Collins* and *Stedeford v Beloe*. In the former, the will which permitted the payment to be made also limited the class of persons who would be entitled to any payment made pursuant to it to the named beneficiaries. The beneficiaries therefore, by virtue of that status, were entitled to the payment, had a sufficient connection to the source, and were liable to tax on the income. By contrast, in the latter, the payment was made pursuant to the college statutes, under which only the College was a beneficiary. It could therefore not be said that the former headmaster was entitled to the payment by reference to that instrument. He had no identifiable source of the income beyond the College's generosity, but a voluntary payment of that kind was not taxable.

82. Here, the source of the Share Recipient's income was the Loan Agreement, in which it was the named beneficiary. It was entitled to receive the shares, by reason of its being so named, even if it did not have the capacity to enforce that entitlement itself: it was in a similar position to that of the beneficiaries in *Drummond v Collins* but not in an analogous position to that of the former headmaster. Although, in *Cunard's Trustees*, the court was addressing the question whether the payments were or were not voluntary, what Lord Greene said (see para 67 above) was equally relevant to the question whether there was a connection between the recipient and a source. The source in that case was "the joint operation of the will and the exercise of their discretion by the trustees." Once it was accepted (as the taxpayers had done in their skeleton argument) that the shares were derived from the Loan Agreement there was no need to enquire further: the source of the shares was identified, and sufficient.

83. On this issue we prefer Mr Ghosh's arguments. Although we accept Mr Prosser's argument that the categories of property and activities do demonstrate what constitutes a necessary connection, we are not persuaded that the test for necessary connection is limited to them. In short, Mr Prosser's test under this head is too narrow. It implies that "possession" is to be equated with ownership, but we do not find anywhere in the authorities to which we were referred any support for the proposition that ownership is required. The beneficiaries in *Drummond v Collins* and *Cunard's Trustees* did not own the fund from which their income was derived, but they were nevertheless found to "possess" (if that is the right word—as we have said, other terms have been used) a sufficient connection to the source.

84. We think, rather, that Mr Ghosh is correct to say that the required connection between taxpayer and source need not be limited to legal rights but can include the situation where the payment is made pursuant to any legal duty owed by the payer. That proposition is consistent with what was said by Lord Greene in the passage we have set out at para 67 above, in which the focus was on the payer's obligation to the recipient, and not on the recipient's ability to enforce it.

Conclusion on the Share Recipient Issue

85. In our view Mr Prosser's approach in saying that the Share Recipient must have a legal right to have the shares issued and allotted to it is, as we have said, too narrow. The Borrower had an absolute and unconditional obligation to allot and issue the shares to the Share Recipient, that obligation was in no sense voluntary and we consider this obligation to be a sufficient legal basis to constitute the necessary connection between the Share Recipient and the Loan Agreement. The fact that the Borrower might have failed (although in fact it did not) to issue the shares, thus breaching its obligation, does not give the issue of the shares the character of a voluntary payment.

86. Accordingly, we dismiss the appeal on the Case VI Issue.

Employer Contributions to Employee Pension Schemes

87. We should mention one other matter. Mr Prosser cited the case of employer contributions to employee pension schemes as indistinguishable from the current scheme. The employment contract obliges the employer to make contributions to an approved retirement benefit scheme. The trustees are not parties to the contract but have an absolute obligation to the employee. Trustees are not taxed on the contributions to the scheme and Mr Prosser maintained that this was because the trustees did not have the necessary connection to the employment contract source. However, without expressing a concluded view, we would maintain that the case cited by Mr Prosser is probably distinguishable. Even if (a moot point) the payments are regarded as the trustees' income, the basis for the employer's payment is to settle income on the employee in the form of a trust. This basis may well be insufficient to generate the necessary connection between the trustees and the source. In any event, special rules apply to approved retirement benefit schemes.

MRS JUSTICE PROUDMAN **JUDGE COLIN BISHOPP**

UPPER TRIBUNAL JUDGES
RELEASE DATE: 25 FEBRUARY 2015