[2013] UKUT 0276 (TCC)
Appeal number FTC/22/2012

Corporation Tax- whether the profit on loan notes is subject to the charge to corporation tax under the loan relationship rules. Construction of s. 84(2)(a) of and paragraph 12 of Schedule 9 to the Finance Act 1996. Profits realised on loan notes which the company had agreed to appropriate to share premium account on the issue of shares for the loan notes were not amounts required to be transferred to its share premium account within the meaning of s. 84(2)(a); the profit appropriated to share premium account was not excluded from the scope of s. 84(2)(a) by paragraph 12 of Schedule 9. Appeal and Cross-appeal dismissed.

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

VOCALSPRUCE LIMITED

Appellant

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

TRIBUNAL: The Hon Mrs Justice Proudman DBE and Judge Edward Sadler
Sitting in public at the Rolls Building Fetter Lane London EC4A 1NL on 17 and 18 April 2013

Mr Jonathan Peacock QC and Mr Michael Ripley, counsel, instructed by PricewaterhouseCoopers Legal LLP for the Appellant

Mr Julian Ghosh QC, Miss Elizabeth Wilson and Miss Barbara Belgrano, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs for the Respondents

DECISION

TRIBUNAL JUDGES: The Hon Mrs Justice Proudman DBE and Judge Edward Sadler

RELEASE DATE:

1. This is an appeal against a decision of the First-Tier Tribunal ("the Tribunal"), Judges Roger Berner and Howard Nowlan, released on 21 December 2011. Permission to appeal was granted by Judge Berner on 23 February 2012.

2. The appeal concerns a tax scheme which was marketed on the basis that, if successful, it would remove the accrued profit on loan notes from charge to corporation tax under the loan relationship rules. This case is a lead case for several companies, in addition to the Appellant, which carried out the scheme.

3. The appeal involves two issues. First, whether the Appellant has received any amounts required to be transferred to its share premium account within the meaning of s. 84(2)(a) of the Finance Act 1996 ("FA 96"). If HMRC are successful on this issue then the appeal fails. However HMRC have another string to their bow in the event of failure on the first issue. This is whether paragraph 12 of Schedule 9 to FA 96 excludes the share premium profit arising to the Appellant from the scope of s. 84(2)(a). In the Tribunal the Appellant was unsuccessful on the first issue but successful on the second. Accordingly, the Appellant lost the case and has appealed the first issue. HMRC have served a respondent's notice on the second issue.

4. The facts are common ground and are set out in paragraphs 10 to 12 of the decision of the Tribunal. In brief:

   - The Appellant was at all material times a subsidiary of Brixton PLC ("PLC").

   - On 18 December 2003 PLC subscribed for zero coupon loan notes issued by various companies in PLC's Group at a discount to face value. The aggregate principal amount of the loan notes was £55,376,343, payable on 17 December 2004.

- On 5 January 2004 PLC entered into an agreement ("the Share Subscription Agreement") with the Appellant for the subscription of 51,701,782 ordinary £1 shares issued by the Appellant. Under the Share Subscription Agreement each share was paid up £1 as to nominal value and £0.071 as to premium, it was agreed that in payment up of the nominal value of the shares PLC would assign the loan notes to the Appellant and it was agreed that the premium would be paid up by capitalising profits arising on the loan notes and appropriating these sums to the Appellant's share premium account. PLC undertook to pay any unpaid premium in the event that the profits arising on the loan notes were insufficient for that purpose.

- It is common ground that the market value of the loan notes was equal to the paid up value of the shares so issued.

- Also on 5 January 2004 the Appellant passed an ordinary resolution increasing its share capital from £1,000 to £51,702,782 by the creation of 51,701,782 ordinary £1 shares ranking pari passu with its existing ordinary £1 shares.

- Also on 5 January 2004 the Appellant passed a special resolution amending its articles of association by the insertion of a new Article 4, requiring the directors (a) to capitalise all and any realised profits arising on the loan notes (whether accrued or received) within 30 days after 31 December 2004 and (b) to appropriate the capitalised sum to the Appellant's share premium account, applying it towards paying up the unpaid premium on the shares.

- On 27 July 2004 the Appellant passed a special resolution amending Article 4 requiring the directors to approve the appropriation of capitalised amounts to the share premium account and the application of these amounts towards the unpaid premium of the shares on particular dates.

- The profits arising on the loan notes were incrementally realised and posted to the Appellant's profit and loss account.

- Thereafter the Appellant capitalised the realised profits and transferred them to its share premium account.

- Expert evidence was given on both sides as to accounting treatment. The Tribunal relied on the requirements of generally accepted accounting practice in the United Kingdom ("UK GAAP") (FRS3 Reporting Financial Performance) and indeed found that there was no alternative accounting treatment for the purposes of FA 96 s. 85. Initially recording the income from the loan notes in the profit and loss account was in accordance with UK GAAP. The transfer of the amount equal to the profit accruing on the loan notes from profit and loss account to share premium account was required by the articles of association and the accounting treatment of that transfer as a movement in shareholders' funds was also in accordance with UK GAAP.

Issue 1: the application of s. 84(2)(a) FA 96

5. The first issue we have to decide is whether the amounts arising to the Appellant (and thereupon capitalised) by way of realised profits on the loan notes (amounting in aggregate to £3,674,561) were amounts required to be transferred to the Appellant's share premium account within the meaning of s. 84(2)(a). If they were such amounts then they are not profits or gains arising to the Appellant from its loan relationships and accordingly are not amounts brought into account as credits for the Appellant's corporation tax purposes.

6. The Tribunal decided against the Appellant on this issue. The Appellant disputes that decision, and so first it is necessary to see how the Tribunal came to its conclusion.

The Tribunal's decision

7. The Tribunal's decision sets out the context – the provisions for taxing loan relationships – in which s. 84(2)(a) is to be found, and the particular statutory provisions in the Finance Act 1996 relevant to this appeal. It also sets out the provisions in the Companies Act 1985 concerning the share premium account in the accounts which a company is required to maintain.

8. At the material time Chapter II Part IV of FA 96 ("the Code") provided for the taxation of corporate debt such as the loan notes. By s. 80(1) the profits and gains arising to a company from its loan relationships (as defined in s. 81) are chargeable to corporation tax in accordance with the Code. In so far as material, s. 84(1) provides as follows:

> "(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…

9. S. 84(2) provides:

> "(2) The reference in subsection (1) above to the profits, gains and losses arising to a company-
>
> (a) does not include a reference to any amounts required to be transferred to the company's share premium account; but
>
> (b) does include a reference to any profits, gains or losses which, in accordance with generally accepted accounting practice, are carried to or sustained by any other reserve maintained by the company."

10. This subsection was necessary because as a matter of company law a credit to a company's share premium account ranked as a profit available for payment of a dividend: see *Drown v. Gaumont-British Picture Corporation Limited* [1937] 2 All ER 609, explained by Harman J at first instance in *Re Duff's Settlement* [1951] Ch 271 at 724. Following *Drown*, Parliament enacted s. 56 of the Companies Act 1948, effectively assimilating share premium to share capital for this purpose. The rule is now to be found in the (different) provisions of the Companies Act 1985, quoted at [25] of the Tribunal's decision. The Tribunal had this to say about it (at [27]):

> "Although, prompted by questions from the Tribunal, there was some discussion on the applicability of s. 130 [of the Companies Act 1985] in the circumstances of the share issue and capitalisation of share premium in this case, the Respondents [HMRC] did not seek to argue that s. 130 does not apply. We are therefore not required to make any findings in that respect. We are content to assume that the transfer to share premium account was either a function of the obligations under the subscription agreement and the articles of association and the board resolutions of the Appellant, or a function of those obligations together with s. 130. Either way, it is common ground that the applicability or otherwise of s. 130 itself is not determinative of this appeal."

11. It is common ground, as the Tribunal observed, that in interpreting the statute the relevant provisions should be construed purposively in accordance with the guidance given by the House of Lords in *Barclays Mercantile Business Finance Limited v. Mawson* [2005] STC 1 at [36]. In carrying out that task the Tribunal noted that the language of s. 84(2)(a), where it speaks of "any amounts required to be transferred to the company's share premium account" corresponds to the language in s. 130 Companies Act 1985. The Tribunal referred to a number of authorities relating to the nature of share premium in company law, and in particular to *Duff*, both at first instance and in the Court of Appeal. In that case it was noted that on a subscription for shares, the amount received by a company as a premium above the nominal value of the shares allotted "represents a profit in the sense that the company got more for its shares than their nominal value". Such a profit, which before the introduction in the Companies Act 1948 of the statutory predecessor of s. 130 Companies Act 1985 was held, as we have said, to be a reserve available for distribution as a dividend, is no longer distributable. From its consideration of these company law matters the Tribunal concluded (at [37]):

> "The important point, we consider, is that share premium could represent a profit, and that the draftsman evidently considered that there were circumstances in which such a profit ought not to be taxable under the loan relationships code. The legislative purpose of s 84(2)(a) was to eliminate the charge to tax in those circumstances."

12. The Tribunal then went on to consider the circumstances in which s. 84(2)(a) has that effect of eliminating the tax charge on share premium where it represents a profit. The Appellant argued that the use of the word "transferred" in the section includes the Appellant's circumstances where the profit realised on the loan notes, having first been credited to profit and loss account, is, by a requirement in the articles of association and the Share Subscription Agreement, capitalised and transferred to share premium account. The Tribunal's view (see [41] and [42] of the decision) was that the use of the term "transferred" was not determinative but could encompass all means whereby share premium is credited to share premium account. It decided that the effect of s. 84(2) was limited to excluding profits that arise only by reason of the relevant amount being a share premium required to be transferred to share premium account and did not exclude profits that accrued to or were carried to any other account. It said (at [42]):

> "Accounts that are purely internal administrative accounts such as suspense accounts on certain share subscriptions, in which an amount paid as a share premium might temporarily be held prior to the premium being transferred directly to share premium account, can be disregarded. On the other hand, a profit that is credited to profit and loss account is not excluded from the meaning of 'profits, gains and losses' in s.84(1) by a subsequent transfer to share premium account, even if there is an obligation to make such a transfer at the time the profit accrues."

13. After considering s. 84(2)(a) in the context of s. 84(2) taken as a whole, and the Appellant's argument that in applying s. 84(2)(a) to the profit it realised on the loan notes one looks only to the end result (that the realised profit is transferred to share premium account), the Tribunal concluded that the evident purpose of s. 84(2)(a) was to take out of account for tax on loan relationships an amount which would be a profit only by virtue of its being a premium on the issue of shares, and not for any other reason.

The Appellant's submissions

14. In his submissions to us Mr Peacock encouraged us to apply s. 84(2)(a) in accordance with its plain words: the section speaks of "*any amounts* required to be transferred to the company's share premium account", and he argued that the Tribunal was in error in construing and applying s. 84(2)(a) in a manner which he submitted qualifies or limits its clear and obvious meaning.

15. The profits realised on the loan notes were, by reason of the legal contractual requirements of the Appellant's articles of association and the Share Subscription Agreement it had entered into with PLC, taken together with the provisions of s. 130 Companies Act 1985, amounts required to be transferred to its share premium account. It was irrelevant that, at the point those profits were realised they were first credited to the Appellant's profit and loss account. The only relevant question is what is the ultimate destination of the amount in question. If that destination is share premium account, s. 84(2)(a) provides that notwithstanding that it is otherwise a profit arising from a loan relationship, it is not to be brought into account as such for tax purposes. Correspondingly, s. 84(2)(b) (which must be dealing with circumstances other than those within s. 84(2)(a)) ensures that profits arising from a loan relationship are brought into account as such for tax purposes where their ultimate destination is a reserve maintained by the company.

16. In Mr Peacock's submission the Tribunal limited the proper application of s. 84(2)(a) by identifying one type of transaction – described by the Tribunal as the paradigm example – which falls within the section (the issue of shares at a premium in exchange for the release of a debt) and deciding that the section must be limited to like transactions where the amounts in question are profits only by virtue of being share premium. In such a case, however, the amount which is only a profit by virtue of being a share premium may differ from the underlying "commercial" profit arising from the loan relationship, and it is clear from s. 84(1) that the focus of these provisions is the commercial profit or gain arising from loan relationships.

17. Furthermore, the Appellant argues, the Tribunal was wrong to limit the ambit of s. 84(2)(a) by reference to accounting distinctions – s. 84 draws a

distinction between the profits, gains and losses arising from loan relationships and the credits and debits which have to be brought into account for tax purposes, as those credits and debits represent such profits, gains or losses by the application of an authorised accounting method. It is thus irrelevant that the profit realised on the loan notes is first credited to the profit and loss account (although if that is taken into account, so also should be the debit when the profit is transferred to share premium account) – the only question is whether that profit is an amount "required to be transferred to the company's share premium account", which in the Appellant's circumstances it is.

18. In the Appellant's submission the Tribunal limited the scope of s. 84(2)(a) in a third respect, by holding (at [47]) that the words "required to be transferred to the company's share premium account" mean "a present requirement to transfer to share premium account at the time when the profit accrues." The Tribunal went on to hold that since the terms of the Share Subscription Agreement and the articles of association did not give rise to a present requirement to make such a transfer at the time the profit was realised (but instead a present obligation to make a future transfer), the section did not apply to the Appellant's circumstances. Such a temporal distinction, the Appellant argues, is not consistent with s. 130 Companies Act 1985, to which the terms of s. 84(2)(a) are closely related – the question is whether an obligation exists to transfer an amount to share premium account: if it does, it is irrelevant that the obligation is discharged at a later date. In any event, s. 84 looks to debits and credits which "fairly represent, *for the accounting period in question* all profits, gains and losses" arising to a company from its loan relationships. It is necessary to look to the position at the end of the accounting period in order to determine whether a profit, gain or loss is taxable in respect of that accounting period, rather than the position as it appears from a snapshot at a particular moment in the course of that period.

The Commissioners' submissions

19. For the Commissioners Mr Ghosh pointed out that s. 84 is concerned with credit and debits brought into account from profits, gains and losses arising from loan relationships; profits, gains and losses arising from "related transactions" (defined by s. 84(5) to mean any disposal or acquisition of rights or liabilities under a loan relationship, for example, an assignment of a debt); interest under a company's loan relationships; and charges and expenses incurred by a company under its loan relationships and related transactions. S. 84(2)(a) excludes from the first two of these categories any amounts required to be transferred to the company's share premium account; s. 84(2)(b) preserves within the charge any profits, gains or losses which are carried to or sustained by any other reserve.

20. Mr Ghosh submitted that the exclusion in s. 84(2)(a) is to protect from the tax charge the profit which arises to a debtor when that debtor issues shares at a premium to its creditor on the capitalisation of a debt (either upon the release or by way of the repayment of that debt) and such release or the amount treated as repaid (or a part thereof) is set off against the share premium which otherwise the creditor to whom the shares are issued on the capitalisation would be required to pay – the Tribunal gave one example of such an instance, describing it as the paradigm case. The amount of the premium, directly transferred to share premium account, is a profit arising from a related transaction (the release of the debt) and would otherwise be brought into account in the tax computation as a credit were it not excepted from such treatment by s. 84(2)(a).

21. By contrast, Mr Ghosh submitted, the profit arising and realised on the loan notes held by the Appellant is, as the accountancy experts agreed, correctly accounted for as part of the profit and loss account, and only then is it, pursuant to the articles of association and the Share Subscription Agreement, transferred to the share premium account. This distinguishes the Appellant's circumstances in two ways from the case where the debt is capitalised on release or repayment for shares issued at a premium: first, if accounts were drawn up immediately after the profit were realised then the profit would be shown in the profit and loss account (and not in share premium account), and s. 84 would apply to bring the resulting credit into account for the Appellant's corporation tax purposes; and, secondly, the appropriation or transfer to the Appellant's share premium account in no sense arises from the Appellant's relationship as creditor of the borrower – it arises because the Appellant is the assignee of the loan notes and pursuant to the obligations imposed on it, as such assignee, under the articles of association and the Share Subscription Agreement.

22. The Appellant has realised, as creditor in the loan relationship, the profit on the loan notes at the point that that profit is credited, according to an authorised accounting method, to its profit and loss account: at that point it is a profit which is carried to a reserve, and by reason of s. 84(2)(b) is a profit arising from a loan relationship for which a credit is to be brought into account under s. 84(1). The subsequent transfer of that amount from profit and loss account to share premium account is irrelevant for the purposes of the loan relationship rules, and this is so even if such transfer is made pursuant to an existing obligation. This was fully understood by the Tribunal (see [45] and [46]), and formed the basis of its decision.

Discussion

23. The scheme for the taxation of profits and gains arising from loan relationships (and for relief for deficits on loan relationships) is

straightforward, at least in its principle. The amount brought into the corporation tax charge for a particular accounting period of a company is computed using the credits and debits for that accounting period in respect of the company's loan relationships (s. 82(1)).

24. S. 84 explains how those credits and debits are determined. Leaving aside interest and charges and expenses in relation to a company's loan relationships, the general rule is that credits and debits are the sums which represent all profits, gains and losses of the company arising to the company from its loan relationships and related transactions (that is, the disposal or acquisition of rights or liabilities under a loan relationship). Such sums are as ascertained by the application of an authorised accounting method (such as UK GAAP, in the Appellant's case).

25. To this general rule there is the exception with which this case is concerned: any amount required to be transferred to the company's share premium account is not to be treated as a profit or gain arising to a company from its loan relationships and related transactions. Any profit or gain arising to a company from its loan relationships and related transactions which, in accordance with generally accepted accounting practice, is carried to any reserve maintained by the company (other than share premium account) is to be treated as a profit or gain for which a credit is to be brought into account (and correspondingly a debit is to be brought into account for any loss sustained by any other such reserve).

26. The purpose of s. 84(2)(a), which provides this exception to the general rule, is clear. On the issue by a company of shares at a premium, the amount or value of that premium is required to be transferred to the share premium account in the books of account of the company and, in broad terms, it is treated as paid up share capital of the company with the attendant restrictions limiting reduction of share capital. This has been the case since the Companies Act 1948. Nevertheless, for the company the amount or value of the share premium represents a profit – for that reason the pre-1948 authorities held, as the Tribunal noted, that it was available for distribution to shareholders as a dividend. Its character as a profit is unaffected by the provisions introduced in 1948 and now to be found in s. 130 Companies Act 1985 – those provisions specify that the amount of the premium must be identified in a share premium account, and restrict how that account may be applied, but do not change the inherent nature of the premium as a profit: see *Re Duff*.

27. The profit, in the hands of the company, in respect of the premium on the issue of shares is the difference between the nominal value of the shares issued and the total amount or value subscribed for the shares – that is, the entire amount of the premium. In a sense it is an arbitrary amount. If, in the context of a loan relationship, we take the example of a debtor company which issues

shares to its creditor to capitalise debt of £100, the company might issue, say, 100 shares of £1 each (and thus not at a premium) or 10 shares of £1 each at a premium of £9 per share. Which of these (or any other possible variant) it chooses may be determined or influenced by factors unrelated to the debt itself – such as the number and nominal value of shares comprising its existing share capital, and whether that share capital is held by parties other than the creditor. The important point, in the context of the loan relationship rules, is that the amount of the profit comprising the premium bears little or no relationship to any profit inherently arising from the terms of the loan relationship itself, or even arising from the dealing in the loan relationship. It is for this reason that it is excluded from the profits to be treated as a credit for loan relationship purposes and so excluded from the tax charge. Mr Peacock argued that it is excluded because it is not, as share premium, distributable as a dividend, but s. 84 looks to the quantum of profits, gains and losses arising from loan relationships, and this is the context in which the purpose of s. 84(2)(a) is to be understood.

28. It follows from this purpose that s. 84(2)(a) relates to those circumstances where the amount required to be transferred to share premium account is the profit arising by reason of the shares being issued at a premium, and it is that profit, so arising, which is excepted from the profits and gains giving rise to credits to be brought into the tax charge. This was the conclusion of the Tribunal, and we agree.

29. In the Appellant's case shares with a nominal value of £1 were issued for an agreed subscription price such that there was a premium per share of £0.071. The loan notes which PLC held as creditor were assigned by PLC to the Appellant in payment up of the nominal value of the shares issued, and it was agreed that subsequent realised profits arising on the loan notes would be capitalised by the Appellant and applied in payment up of the premium. PLC stood as backstop to pay up the premium on the shares should for any reason there be a shortfall in the amount of realised profits arising on the loan notes.

30. These arrangements do not accord with the circumstances at which in our view s. 84(2)(a) is directed. We agree with Mr Ghosh that the profit arising to the Appellant from its loan relationship (the loan notes) arises in its capacity as creditor (it having taken an assignment from PLC of the creditor rights), not in its capacity as the issuer of shares at a premium – the amount due to it as creditor is simply applied in payment up of the premium, and it receives other payment (from PLC, and unconnected with any loan relationship) if and to the extent that realised profits arising to it on the loan notes fall short of the amount required to pay up the premium on the shares.

31. This, as the evidence of the accountancy experts makes clear, is reflected in the accounting treatment which UK GAAP requires to record the various

transactions. In particular, the profit of £3,674,561 arising on the loan notes to the Appellant (following its acquisition of the loan notes) was credited as a realised profit to the Appellant's profit and loss account for the accounting period in question. That, we consider, fully deals with the profit arising to the Appellant from its loan relationship, within the terms of s. 84(1)(a). It is not an amount required to be transferred to the Appellant's share premium account but, in the terms of s. 84(2)(b) it is a profit which, in accordance with generally accepted accounting practice, is carried to a reserve (profit and loss account) maintained by the Appellant which is a reserve other than share premium account. As a separate exercise, and separately accounted for, once the directors of the Appellant had resolved to capitalise the profit realised on the loan notes, that sum, £3,674,561, was transferred from profit and loss account to share premium account, being accounted for as a movement in shareholders' funds. Those steps, and the accounting entries by which they were recognised in the Appellant's books, were distinct from the realisation of the profit from the loan relationship and the accounting entries by which that realisation of profit was recognised. This is so notwithstanding that the Appellant had agreed to apply the profit realised on the loan notes in payment up of the premium at which it had issued the shares to PLC.

32. By contrast, as the evidence before the Tribunal made clear, where shares are issued at a premium for cash or other assets (so that the amount of the premium is thereby immediately and directly a profit to the issuing company), the amount of the premium is accounted for directly, and without intermediate or intervening steps, as share premium and credited to that account. (In a public subscription, where cash subscribed is remitted over a period, it may be held in a subscription or allotment account until the actual share issue, but the Tribunal rightly regarded this as an administrative convenience and not a substantive matter of accounting treatment reflecting the nature and effect of the transaction.)

33. The Appellant's principal argument, before us as before the Tribunal, is that s. 84(2)(a) is in terms of "any amounts required to be transferred to the company's share premium account", and that the Appellant was required, by the contract it made with PLC comprised in the Share Subscription Agreement and the articles of association, to transfer from profit and loss account to share premium account an amount representing the realised profit on the loan notes. The language of s. 84(2)(a) is wide enough, the Appellant argues, to encompass the entirety of the transactions undertaken by the Appellant, since the question is where, on completion of those transactions, that profit is accounted for – in the Appellant's case, share premium account.

34. The Tribunal dismissed this argument, holding (at [45] and [46]) that since the profit on the loan notes, upon realisation, is credited to profit and loss account, it is then and thereby a profit arising to the Appellant from its loan relationship

carried to a reserve other than share premium account and hence is to be brought into account as a credit. Whatever subsequently may happen, even if pursuant to an existing arrangement, does not change or detract from that fact and that consequence. We agree with the Tribunal, and would only add the point already made, that the realisation of the profit on the loan notes and the crediting to the profit and loss account of that profit completes, so to speak, the steps whereby profit arises to the Appellant as creditor in its loan relationship; the capitalisation of that profit and the transfer of that capitalised amount to share premium account is undertaken pursuant to a different relationship which in itself gave rise to no profit for the Appellant.

35. Mr Peacock argued that it is necessary to look to the position at the end of the accounting period, by which time there was no longer an amount in the profit and loss reserve representing the realised profit on the loan notes, but only an amount in share premium account. S. 82(1) provides that for corporation tax purposes the profits and gains arising from loan relationships of a company are to be computed "using the credits and debits given for the accounting period in question". We consider that if a profit arises to a company from a loan relationship then that is a credit for the accounting period in which it arises. That remains the case notwithstanding that the company chooses, or is even obliged, to take further action in relation to the profit in question. Mr Peacock then argued that, when the amount of capitalised profit is transferred to share premium account there should be a corresponding debit taken into account in the loan relationship profits and losses computation. The difficulty with that, however, is that such transfer is not a loss of the Appellant, and certainly not a loss arising from a loan relationship or a related transaction. No debit therefore arises.

36. More generally, Mr Peacock struggled to provide us with any rationale or policy to support the Appellant's construction of s. 84(2)(a). Had the loan notes been interest-bearing, instead of issued at a deep discount with a zero coupon, and had the Appellant and PLC entered into an identical transaction, but with accrued interest to be capitalised and applied to pay up the premium on the consideration shares issued by the Appellant, that interest would not on any basis be within the scope of the exception provided by s. 84(2)(a) (which relates only to profits, gains and losses arising from a loan relation, and not to interest under a loan relationship). Similarly, if the Appellant had issued the consideration shares at nominal value, to be paid up in part from capitalised profit realised subsequently on the loan notes (that is, shares not issued at a premium), the profit so realised would not have been protected from the loan relationship charge by s. 84(2)(a). Both these possible transactions, financially and in company law directly comparable to the transaction entered into by the Appellant, demonstrate that there is no discernible rationale for s. 84(2)(a) if it is to be construed as the Appellant would have it construed – certainly the inability to distribute the realised profit by way of dividend provides no rationale, since that is common to all three transactions. This

absence of any rationale or policy basis for the Appellant's interpretation fortifies us in our conclusion that the Tribunal correctly dismissed the Appellant's appeal on the ground that s. 84(2)(a) does not have the effect of excepting the realised profits arising on the loan notes from those profits and gains which give rise to a credit to be brought into account for corporation tax under the loan relationship provisions.

37. Accordingly, we dismiss the Appellant's appeal to this tribunal.

Issue 2: the application of Para 12 of Schedule 9 to FA 96

38. HMRC's alternative argument is that paragraph 12 of Schedule 9 to FA 96 has the effect of excluding the share premium profit arising to the Appellant from the scope of s. 84(2)(a). We propose to deal with HMRC's cross-appeal on this issue shortly as on the basis of our findings it does not arise.

39. In so far as material, this paragraph provides as follows:

> "(1) …this paragraph applies where, as a result of-
>
> (a) a related transaction between two companies that are-
>
> (i) members of the same group, and
>
> (ii) within the charge to corporation tax in respect of that transaction,
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> one of those companies ('the transferee company') directly or indirectly replaces the other ('the transferor company') as a party to a loan relationship.
>
> (2) The credits and debits to be brought into account for the purposes of this Chapter in the case of the two companies shall be determined as follows-
>
> (a) the transaction, or series of transactions, by virtue of which the replacement takes place shall be disregarded except-…..

> …(ii) for the purpose of identifying the company in whose case any debit or credit not relating to that transaction, or those transactions, is to be brought into account; and
>
> (b) the transferor company and the transferee company shall be deemed (except for those purposes) to be the same company."

40. It is common ground that the assignment of the loan notes was a related transaction (as defined by s. 84(5)) for the purposes of paragraph 12(1) and that the Appellant replaced PLC as a party to a loan relationship.

41. The Tribunal held that it was central to the purpose of paragraph 12 that if the terms of the assignment would otherwise occasion loan relationship profits and losses that effect should be disregarded, but that was the limit of the statutory disregard. Accordingly it was held that any debits or credits arising on the assignment (in fact there were none) would be ignored so that they would not be taken into account for tax purposes.

42. The Appellants submitted that the Tribunal was correct in holding that this was as far as the statutory fiction went; however, HMRC as cross-appellants argued that the Appellant's agreement to capitalise the profits arising on the loan notes and transfer them to the share premium account should also be disregarded.

43. Mr Ghosh's argument was as follows. The transaction by virtue of which the replacement of PLC by the Appellant as a party to the loan relationship took place was the assignment of the loan notes. Under that transaction PLC was obliged to transfer the loan notes and the Appellant was obliged to capitalise profits arising on the loan notes and transfer them to its share premium account. Accordingly, so the argument runs, paragraph 12 requires the entirety of that transaction to be disregarded so that both the assignment and the agreement to capitalise profits fall to be ignored in the calculation of debits and credits. He argued that it is wrong in principle to disregard the transfer of loan notes while giving effect to another limb of the same transaction, namely the agreement to capitalise profits and transfer them to the share premium account.

44. However we, in common with the Tribunal, prefer Mr Peacock's submissions under this head. The purpose of the statutory fiction appears from the Explanatory Notes to the Finance Bill 1996. It is to allow debt to be moved around a group without incurring tax. Without this provision the transfer of debt between companies in a group could crystallise a profit or loss where a debt is transferred for a value other than the value carried in the accounts. The

provision is concerned only with the related transaction as defined by s. 84(5), namely "any disposal or acquisition…of rights or liabilities under that relationship [the loan relationship]". Thus the fiction created by paragraph 12 is only relevant in identifying (for the purpose of disregarding) those credits and debits which are to be brought into account from the related transaction and does not determine whether credits constitute profits or gains for the purpose of s. 84.

45. We would therefore dismiss the cross-appeal.

MRS JUSTICE PROUDMAN DBE and JUDGE EDWARD SADLER

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