QCB Or Non-QCB, That Is The Question!

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Pete Miller explores the recent case of Anthony and Tracy Lee Hancock who managed to avoid capital gains tax on most of the proceeds of selling their company. They were able to exploit a defect in the gateway conditions of TCGA 1992, section 116, converting a mixed holding of qualifying and non-qualifying corporate bonds into qualifying corporate bonds which were exempt from capital gains tax on redemption.

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The Facts

Mr. and Mrs. Lee sold their trading company in August 2000, for consideration of GBP9.27m, with a further earn-out. Mr. Hancock received GBP500,000 A loan notes, which were not part of the planning and are not mentioned further. He also received GBP4.1m B loan notes and Mrs. Lee Hancock received GBP4.6m B loan notes. There was a clause entitling the Hancocks to require the loan notes to be redeemed in US dollars, which it was agreed meant that the loan notes were not qualifying corporate bonds (non-QCBs).

For tax purposes, the exchange of shares for non-QCB loan notes is treated, by virtue of TCGA 1992, sections 135 and 127, as not involving any disposal at all, so that the loan notes effectively stood in the shoes of the original shareholdings. Capital gains tax would accrue as and when the loan notes were redeemed or otherwise disposed of, and the gain would be based on the consideration received on redemption or disposal. For example, if the purchaser company became insolvent and the loan notes became worthless, no gain would arise.

This treatment depended on there being a *bona fide* commercial purpose for the transactions, which would have been Mr. and Mrs. Hancock's sale of their business. It was also a requirement that there not be a scheme or arrangement for the avoidance of capital gains tax or corporation tax. It is assumed that HMRC had accepted that these conditions were satisfied, and there is nothing in the case report to suggest that the future planning was in contemplation at the time of the original sale of the company.

The earn-out subsequently came to fruition such that Mr. and Mrs. Hancock each received a further GBP477,000 of B loan notes on March 22, 2001. The tax treatment of the earn-out is similar to the share for non-QCB exchange described above. First, TCGA 1992, section 138A treats the earn-out right as if it were a non-QCB loan note. So the pay-out in the form of further non-QCB loan notes is treated as a conversion of the earn-out non-QCB into the new non-QCB loan notes. TCGA 1992, section 132 provides that such a conversion of loan notes is also treated as if there were no disposal and no acquisition, so that the new B loan notes issued to Mr. and Mrs. Hancock were also treated as standing in the shoes of the original shares and no capital gains tax would accrue until the loan notes were redeemed or otherwise disposed of.

While the original sale in return for the earn-out right needed to have a *bona fide* commercial reason and not have a CGT or CT avoidance motive, the "conversion" of the earn-out to actual non-QCB loan notes under TCGA 1992, section 132 does not have any such conditions.

So, by March 2001, Mr. and Mrs. Hancock held around GBP9.7m of B loan notes of the purchaser company. Assuming these were in due course to be redeemed at full value, substantial capital gains would have arisen to them on the redemption of these loan notes, originally intended for 2004.

The Planning

The B loan notes were redeemable in 2004, although the Hancocks could require early redemption on specified dates. When they decided, in 2002, that they would like to redeem the loan notes, they consulted with their accountants, Haines Watts. Haines Watts suggested that some tax planning might be available, with the co-operation of the purchasers, *i.e.* the issuers of the loan notes, and it appears from the case report that Pricewaterhouse Coopers were also involved in the planning.

The essence of the planning was that the GBP477,000 B loan notes that each of Mr. and Mrs. Hancock had received in March 2001 were to be converted into qualifying corporate bonds (QCBs), the "Revised B loan notes," by a deed of variation, which removed the right to redemption in US dollars. This was executed on October 9, 2002.

For tax purposes, this is, *prima facie,* another conversion of securities to which TCGA 1992, section 132 applies, so that the Revised B loan notes would be treated as if they were the same B loan notes as they had been previously. As noted above, the "conversion" under TCGA 1992, section 132, in this case of the non-QCB loan notes to QCB loan notes, does not require the satisfaction of any conditions regarding commerciality or tax avoidance.

Moreover, QCBs are exempt from capital gains tax (by TCGA 1992, section 115), so without further legislation this would be a very easy way to avoid capital gains tax on a disposal; sell your shares, receive QCB loan notes and redeem them tax free!

This is prevented by the operation of TCGA 1992, section 116 which largely provides that, where

a non-QCB security (*i.e.* shares or loan notes) is being reorganized or converted into a QCB loan note, the capital gain arising on a disposal of the non-QCB is computed, but held over and comes into charge only when the QCB loan notes are redeemed or disposed of. The crucial difference between QCB and non-QCB loan notes, therefore, is that the charge has already been computed and the capital gains tax becomes payable even if the loan notes themselves eventually are worthless and are never redeemed.

So the overall analysis of the conversion of some of the B loan notes into QCBs is:

- TCGA 1992, section 132 says that this is a conversion of securities, to be treated as if there had not been a disposal of the old securities or an acquisition of the new securities
- TCGA 1992, section 116(10) supersedes this treatment and requires a computation of the gain that would accrue on a disposal of the non-QCB loan notes that were converted, so that, when the QCB loan notes that they had been converted into were redeemed or otherwise disposed of, that gain would come into charge.

The result is that Mr. and Mrs. Hancock now had a mixed holding of B loan notes that were non-QCBs and Revised B loan notes that were QCBs. On May 7, 2003, all of these loan notes were exchanged into Secured Discounted Loan Notes ("SDLNs")which were agreed to be QCBs. These were then redeemed on June 30, 2003, with the associated redemption premium. It is the treatment of this conversion of a mixed holding of non-QCBs (the B loan notes) and QCBs (the Revised B loan notes) which is the subject of the case.

The Hancocks' Argument

Mr. and Mrs. Hancock's argument was based on close inspection of what one might refer to as the "gateway provisions" of TCGA 1992, section 116.

Section 116 applies if "either the original shares would consist of or include a qualifying corporate bond and the new holding would not, or the original shares would not and the new holding would consist of or include such a bond," TCGA 1992, section 116 (1)(b). For these purposes, we can read the original shares as meaning the loan notes held before a reorganization or conversion, and the new holding as being the loan notes held afterwards. We are looking at the conversion of the mixed portfolio of B and Revised B loan notes into SDLNs. On a superficial analysis, this mixed holding is clearly a holding that includes QCBs, and we have already noted that the SDLNs are QCBs. Therefore, since the original shares include QCBs and the new holding is all QCBs, Mr. and Mrs. Hancock argued that the gateway provisions of TCGA 1992, section 116 did not apply and section 116 therefore could not apply to the conversion into SDLNs.

The result of the Hancocks' argument is that the conversion of the mixed portfolio of QCBs and non-QCBs into the SDLNs is a conversion within TCGA 1992, section 132 which is treated as a

reorganization, so that there is no disposal of the old B loan notes nor an acquisition of the Revised B loan notes. Since TCGA 1992, section 116 does not apply, the disposal of the mixed holding of loan notes is exempt from capital gains tax under TCGA 1992, section 115.

HMRC's Position

HMRC argued that tax arose in respect of both sets of B loan notes separately, as follows:

- As regards the non-QCB loan notes, *i.e.* the B loan notes, the conversion into QCB loan notes triggered a gain to be calculated and held over under TCGA 1992, section 116(10), and that gain then crystallized on redemption of the SDLNs;
- As regards the QCB loan notes, a gain had already been computed under TCGA 1992, section 116(10). The conversion from B loan notes into SDLNs was a conversion within TCGA 1992, section 132, so that the new loan notes effectively continued to stand in the shoes of the Revised B loan notes. The subsequent redemption, therefore brought into charge that had been held over under TCGA 1992, section 116(10).

Conversely, if Mr. and Mrs. Hancock's argument were correct (see below), so that no charge arose on the technical analysis, HNRC argued that the *Ramsay* doctrine should be applied, to treat the conversion of the mixed loan note holding on May 7, 2003, and the subsequent redemption of the SDLNs on June 30, 2003, as a single composite transaction of redemption of the B loan notes and Revised B loan notes. In respect of the non-QCB B loan notes, the capital gains tax would come into charge on the basis of their having been redeemed on normal principles, and in respect of the Revised B loan notes, which were QCBs, the gain previously computed under TCGA 1992, section 116(10) would come into charge, on this analysis.

HMRC's argument that that the loan notes should be looked at individually, as above, relied on the fact that the overall scheme of capital gains tax deals with each asset individually before aggregating gains and losses of a person in a given period. The Tribunal came to the view that the legislation relating to conversions and reorganizations of capital clearly contemplated the possibility of the rules being applied to mixed holdings, however. For example:

- TCGA 1992, section 126 refers to holdings of shares of more than one class;
- TCGA 1992, section 127 refers to shares being treated as a single asset even when they would not necessarily otherwise be so;
- TCGA 1992, section 130 refers to mixed holdings of shares or debentures of more than one class or, indeed, for more than one company; and
- TCGA 1992, section 116 itself clearly refers, as we have already seen, to the holdings including QCBs, which implies the possibility of mixed holdings, again.

There is an unfortunate mismatch in TCGA 1992, section 116, in that sub-sections 116(3) and (4) refer to holdings that "comprise" a QCB, which appears to be at odds with the gateway provision in section 116(1)(b). But the Tribunal held that

sub-sections (3) and (4) should be construed as to agree with section 116(1)(b), and not *vice versa*.

The Tribunal also found that HMRC's arguments that the loan notes should be treated separately contravened the clear intention of the words of TCGA 1992, section 116(1)(b), as this provision is clearly "couched in terms that recognize the possibility of the 'original shares' not being wholly comprised of a QCB or a non-QCB." HMRC suggested that this wording had been put in place simply to cover the transitional position on the introduction of the legislation in 1984, an argument dismissed by the Tribunal on the basis that if it had been the intention of Parliament to restrict this analysis to that very narrow set of circumstances, it would have been "straightforward" to draft the rules accordingly.

The Tribunal also decided that they could not "ignore the clear words, and seek to rewrite legislation based on what might be discerned as the true result intended by Parliament. We do not consider that section 116(1)(b) can be construed otherwise than on its own terms." In other words, although they considered it unlikely that Parliament intended the result argued for by the Hancocks, it was not possible to construe the clear words of the legislation in any other way and the Tribunal went on to say that "no purposive construction can fill the gap created by the fact that certain circumstances that might be thought to have been intended to be within section 116 fall outside it according to the clear words of section 116(1)(b)." Furthermore, they stated that they do not see "that the language of section 116(1)(b) admits of an interpretation that can avoid what may be perceived as an injustice or absurdity," so that this was a case "where an anomaly cannot be avoided by any legitimate process of interpretation."

On the *Ramsay* argument, HMRC submitted that, construing the legislation purposively and viewing the facts realistically, the conversion of securities on May 5, 2003 followed by the redemption on June 30 that year should be treated as a single composite transaction. While the Tribunal accepted the inevitability of the redemption of the SDLNs, they did genuinely exist, albeit for a short period, and they were always going to be redeemed eventually. Viewed realistically, the conversion and the redemption could not be conflated and the transaction could not be viewed realistically as the direct redemption of the B and Revised B loan notes.

The Tribunal then looked at whether HMRC got home on a purposive construction of the reorganization provisions of TCGA 1992, section 127 as applied by section 132 to the conversion of the B loan notes. The Tribunal considered that the reorganization provisions in the UK provide a rational system of taxation, effectively delaying the payment of tax until instruments are eventually sold or redeemed. Similarly, TCGA 1992, section 116 was part of that rational tax system, in ensuring that, where the instruments concerned were tax-exempt QCBs, a tax liability could not be effectively rolled up into such a tax-exempt instrument and avoided.

Overall, the Tribunal did "not consider that a purposive construction of the reorganization provisions, including section 132, can produce any different result merely on the basis that the transactions that have been entered into were intended, for tax avoidance purposes reasons, to exploit an anomaly in the application of those rules." Although not explicitly stated in the judgment, one might infer an implied suggestion that the legislation needed to be restricted to circumstances where there is no intention to avoid tax.

Essentially, the Tribunal said that they did not see that a purposive approach to the legislation, which might be described as "closely articulated," would get the Revenue the result they wanted. Indeed, the Tribunal pointed out that HMRC's approach was much more in line with the old style *Ramsay* doctoring, whereby steps could be ignored or conflated where tax avoidance was in point. But this approach was overturned in *BMBF v Mawson* [2005] STC 1, decided by the House of Lords in November 2004.

The Tribunal's decision can be summarized by their comment that "the gap in the legislation … is not capable of being plugged by a process of purposive construction, nor by applying a broad spectrum antibiotic by means of disregarding any element of those transactions."

Where To Next?

Firstly, it seems likely that HMRC will seek leave to appeal this decision to the Upper Tribunal. Reading between the lines, I suspect that there are a number of cases involving this particular planning and HMRC will be keen to get it ruled ineffective. In that context, I see it as unlikely that a superior court would overturn the technical decision, on the basis of the clarity of the words in TCGA 1992, section 116(1)(b). However, the *Ramsay/BMBF* approach, of construing purposively and viewing realistically, is open to a wider range of interpretation, and a superior court might take the view that the inevitability of these steps, the short life of the SDLNs, and the overall intention to avoid tax are sufficient as to allow a different interpretation of a realistic view of the transactions.

It is also possible, indeed maybe likely, that HMRC will seek to change the law. One possibility would be to change the gateway provisions to TCGA 1992, section 116, in order to remove the possibility of using this planning in the future.

Another idea, and one possibly causing less uncertainty of interpretation of new legislation, would be to apply the same tests to a conversion of securities in TCGA1992, section 132 as already applies to a share exchange in TCGA 1992, section 135. That is, to ensure that a conversion of securities is only brought within the reorganization rules if it is carried out for *bona fide* commercial reasons or is not part of a scheme or arrangements with a whole or main purpose of avoiding capital gains tax, corporation tax (and possibly income tax).

It was noteworthy that one of the reasons the Tribunal did not feel that they could find for HMRC

on the basis of a purposive approach to the legislation was that the conversions of securities rules did not contain a requirement that there be a commercial reason for the transactions and that there not be a tax avoidance motive. Had there been such a test in place already, clearly it is unlikely that Mr. and Mrs. Hancock would have survived that test, and the planning would have failed *ab initio*.