Capital gains tax chargeable on mixed qualifying and non-qualifying corporate bonds conversion (Hancock and another v Revenue and Customs Commissioners)

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Tax analysis: Ximena Montes Manzano, barrister at Temple Tax Chambers, examines the Supreme Court's decision in Hancock v Revenue and Customs Commissioners that a conversion of qualifying corporate bonds (QCBs) and non-QCBs in a reorganisation was not a single conversion for the purposes of section 132 of the Taxation of Chargeable Gains Act 1992 (TCGA 1992). Therefore, the final redemption of QCB loan notes which had been indirectly issued to the appellant taxpayers in exchange for their shares in their company remained subject to TCGA 1992, s 116(10). Consequently, deferred gain arising on the shares when they were exchanged for loan notes remained taxable on that final redemption. In particular, it did not fall within the exemption from capital gains tax (CGT) in TCGA 1992, s 115 for disposals of QCBs.

Hancock and another v Revenue and Customs Commissioners [2019] UKSC 24, [2019] All ER (D) 110 (May)

What are the practical implications of the judgment?

Under TCGA 1992, s 127, a reorganisation of share capital is not treated as a disposal of the shares for the purposes of CGT. Instead, any gain on the original shares is 'rolled over' into the new holding (eg shares) and will normally be taxed on the disposal of that holding. Hence the purpose of the legislation is to postpone tax on the initial gain, but not to exempt it outright. The reorganisation rule, which operates to defer the payment of CGT in this way, also applies to the conversion of securities such as loan notes, but 'with any necessary adaptations' under TCGA 1992, s 132(1). However, these rules need to be reconciled with the separate rule that gains on disposing of QCBs are not chargeable to CGT at all. Generally, to qualify as QCBs, bonds must, among other things, not be redeemable other than in sterling. TCGA 1992, s 116 sets out special rules dealing with reorganisations and conversion involving QCBs. These rules (in particular, s 116(10)) aim to ensure that, where gains on shares are deferred because those shares are exchanged for QCBs, the deferred gain does not fall out of the tax charge on a later disposal of the tax-exempt QCB.

The Supreme Court's decision in *Hancock and another v Revenue and Customs Commissioners* concerns conversions of 'mixed' securities (ie a mixture of QCBs and non-QCBs) in return solely for QCBs, as provided by TCGA 1992, s 132.

When considering the tax treatment of a transaction which includes a conversion of QCBs and non-QCBs into QCBs, the words 'with necessary adaptations' in TCGA 1992, s 132(1) allow the different types of asset being converted (ie QCBs and non-QCBs) to be treated as separate conversions. This treatment applies irrespective of how the transaction has been structured as a matter of fact. In other words, even if the 'mixed' conversion is effected in a single transaction (and subject to one single legal document executed for commercial reasons), the wider purpose of the statutory scheme permits that single transaction to be subdivided.

In order to apply the said purpose (which the Supreme Court described as enabling 'all relevant reorganisations to benefit from the same rollover relief'), the words 'or include' in TCGA 1992, s 116(1)(b) should be ignored. This means that each security converted into a QCB should be viewed as a separate conversion. These separate conversions are to be taxed in accordance with TCGA 1992, s 116, and in particular TCGA 1992, s 116(10) which ensures that when shares are exchanged for QCBs, the deferred gain on those shares becomes taxable when the QCBs are disposed of (eg on redemption). The legislation permits these separate conversions despite the lack of statutory guidance on how the consideration should be apportioned between the separate conversions, in the absence of any allocation of price in the contractual documentation.

This decision seems to establish a limitation to the longstanding principle that the subject is only to be taxed by clear words. Where, as here, the court feels able to discern a clear legislative scheme or purpose which application of the clear words used by Parliament would frustrate, those clear words will be ignored so as to tax the subject in accordance with the discerned legislative scheme. The Supreme Court has articulated this decision as an exercise in statutory interpretation. However, it may also be described as legislative in nature as it involves re-writing the statute—ignoring inconvenient words actually used by Parliament.

What was the background?

The appellants each held shares in their company. When they sold the company, they disposed of those shares in four stages.

First, the buyer issued them with loan notes in exchange for their shares. The appeal was concerned only with some of the loan notes. Those notes had been issued in two tranches. The loan notes provided that the note holder could require repayment in US dollars. Hence, they were non-QCBs.

Secondly, it was subsequently agreed that the terms of loan notes in the second tranche would be varied so that they could not be redeemed in dollars. Thereafter, these revised loan notes became QCBs, whereas the unrevised loan notes in the first tranche remained non-QCBs.

Thirdly, both the non-QCB loan notes and the QCB revised loan notes were exchanged for secured discounted loan notes, which were QCBs. This conversion of notes for other notes occasioned no taxable disposal for CGT purposes.

Fourthly, the secured discounted loan notes were redeemed.

The Upper Tribunal, allowing the respondent HMRC's appeal from the First-tier Tribunal, held that the conversion of securities at the third stage comprised separate transactions—non-QCBs into QCBs and QCBs into QCBs. The result was that the conversion of non-QCBs into QCBs fell within TCGA 1992, s 116(1)(b). This in turn activated a tax charge on the deferred gain under TCGA 1992 s 116(10) when the secured discounted loan notes were redeemed at stage four.

The Court of Appeal rejected the appellants' argument that the third stage constituted a single conversion of the loan notes (including QCBs) into QCBs so that TCGA 1992, s116(1)(b) (and hence s 116(10)) would not apply.

The taxpayers appealed to the Supreme Court, arguing that there was no warrant in the language of TCGA 1992, s 116 to treat what was, as a matter of fact, a single transaction as though it were two transactions merely so that TCGA 1992, s 116 could then be applied to those two transactions separately. This strained meaning required the words 'or include' in TCGA 1992, s 116(1)(b) to be disregarded. This clearly infringed the 'clear words principle' established by *W T Ramsay Ltd v Inland Revenue Commissioners; Eilbeck (Inspector of Taxes) v Rawling sub nom Ramsay (W T) Ltd v IRC; Eilbeck (Inspector of Taxes) v Rawling* [1982] AC 300, [1981] 1 All ER 865.

What did the Supreme Court decide?

Dismissing the appeal, the court held that taking into account the purpose and policy behind TCGA 1992, Pt IV, Ch II, there had been two conversions of securities—one of QCBs for QCBs and the other of non-QCBs for QCBs.

Whether there was a single conversion or two separate conversions should be determined by applying TCGA 1992 to the facts and was not predetermined by the way in which the transaction had been structured by a taxpayer. Otherwise the taxpayer could defeat the statutory purpose merely by drafting documents differently.

The appellants' interpretation of the relevant provisions would, if correct, defeat the policy expressed in these provisions. This was plainly 'to enable all relevant reorganisations to benefit from the same rollover relief' and to ensure that deferred gains did not fall out of the charge to tax. If the taxpayers were correct, they could easily avoid the consequences of TCGA 1992, s 116(10) when QCBs were ultimately redeemed, by converting non-QCBs and a minimal amount of QCBs into QCBs. Accordingly, the Court of Appeal had been correct in applying a purposive interpretation to TCGA 1992, s 116(1)(b) by ignoring the words 'or include'. It was clear from TCGA 1992, s 132(3) that Parliament intended each security converted into a QCB to be treated as a separate conversion. The words of TCGA 1992, s 127 were to be applied to conversions with 'necessary adaptations' and this construction could be said to involve such adaptations.

The 'clear words principle' did not confine a court to a literal interpretation, particularly if such an interpretation would produce a result contrary to the evident intention of Parliament. The Supreme Court adopted the Court of Appeal's metaphor and held that, on the true interpretation of TCGA 1992, s 116(1)(b), 'the potential gain within the non-QCBs was frozen on conversion and did not disappear in a puff of smoke'. Instead, it was taxed on the redemptions of the secured discounted loan notes because of TCGA 1992, s 116(10).

Ximena Montes Manzano appeared with Michael Sherry for the appellant taxpayers in this case.

Interviewed by Robert Matthews.

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