Two types of bond

The distinction between qualifying and non-qualifying corporate bonds is important, say **OLIVER WALKER** and **STUART PIBWORTH** as they explain the capital gains tax rules that apply.

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It is often lamented that the advance of texting and social media has led to the unfortunate proliferation of acronyms and abbreviations that now haunt our daily lives. However, tax practitioners are no strangers to this phenomenon: the tax regime is littered with cumbersome terms that have long been subject to abbreviation and are thrown about daily in 'tax speak'. Unfortunately, in some cases these abbreviations make their way into discussions with colleagues and clients who are left struggling to decipher their meaning. At least we do not seem to have moved on to tax emojis … yet.

QCBs and non-QCBs fall squarely into this bucket of abbreviations that, although familiar to tax practitioners, mean nothing to anyone else. That said, at least the tax treatment of QCBs and non-QCBs has become one of the more certain areas of personal taxation over the years, with individuals choosing to acquire one or the other safe in the knowledge of the UK tax implications. However the case of *Hancock and another v CRC* [2016] STC 1433 has thrown some doubt on this subject, so this article explains the key findings and what they mean for taxpayers.

Legislative references in this article are to TCGA 1992, unless stated otherwise.

KEY POINTS

- The recent case of *Hancock* sheds light on the operation of the rules relating to qualifying and non-qualifying corporate bonds.
- Exemptions and tax deferments apply depending on the type of bond.
- The share capital reorganisation provisions apply to the conversion of securities 'with any necessary adaptations'.
- A conversion of chargeable securities into QCBs creates a deemed gain that is payable on a subsequent disposal.
- The court adopted a purposive approach to overcome perceived technical shortcomings in the legislation.
- As a result of *Hancock*, the tax treatment of QCBs may now be less certain.

What is a QCB?

As a brief recap, a QCB is a 'qualifying corporate bond' and, unsurprisingly, a non-QCB is something that is not. This distinction is important because the capital gains tax treatment differs – sometimes widely.

For capital gains tax purposes, a QCB is a security:

- the debt on which represents (and at all times has represented) a normal commercial loan;
- that is expressed in sterling; and
- for which no provision is made for conversion into, or redemption in, any currency other than sterling (other than a redemption provision at the exchange rate prevailing at redemption).

For these purposes, the meaning of a 'normal commercial loan' is different from that used for wider group relief purposes in a corporation tax context but, in short, it means a loan that provides for an arm's length interest rate and does not contain equity-like features.

As illustrated by ***Three Loans***, the principal demarcation of a non-QCB from a QCB is often a non-sterling denomination or currency redemption or conversion provision. For example, a euro conversion clause would usually prevent the debt from being a QCB. Our more senior readers will recall that such a clause included in debt instruments when an adoption by the UK of the euro was a more realistic prospect than it is today.

Capital gains tax

For capital gains tax purposes, a QCB is an exempt asset (TCGA 1992, s 115). Thus, taking the example of ***Three Loans***, if Justin sells the QCB, he would not be subject to capital gains tax on any gain – and, equally, any loss would be disallowed. This may strike the reader as an uncommonly generous rule but, as with many tax 'breaks', the rationale was rooted in a desire to stimulate commerce and, in this case particularly, the UK bond market.

THREE LOANS

As well as owning shares in Company A, which is UK resident. Justin also advanced a plain vanilla £100,000 loan to Company A on normal commercial terms with no provision for conversion or redemption other than in sterling. The loan should be treated as a QCB.

However, Justin also advanced two other loans to Company A on the same terms, but the first is US dollar-denominated and the, second, while sterling-denominated, contains a euro conversion provision at the exchange rate prevailing on the date of the loan. In both cases, these two loans would be treated as non-QCBs.

Before considering the capital gains tax treatment, readers may wonder how a capital gain might arise on a loan. Taking the £100,000 QCB in ***Three Loans***, perhaps the £100,000 loan was made when the commercial arm's length terms included interest payable at, say, 10% but, if made today, the commercial rate may be only 5%. Let's also say that the loan capital is not repayable until the end of the loan term. A purchaser might be prepared to pay more than the £100,000 loaned by Justin because they will receive a higher rate of interest than otherwise obtainable now.

Of course, outside the capital gains tax regime, there may be other tax consequences. For example, the QCB disposed of might be 'pregnant' with accrued but unpaid interest, but that is beyond the scope of this article. Conversely, a non-QCB is a chargeable asset with the result that any gain (or loss) arising on the disposal is treated as a capital gain (or allowable loss), calculated in the normal way. Again, there may be income tax consequences as well.

Given the differing treatment that can result from the simple inclusion of a redemption or conversion provision, questions have been asked in the past on where that sits in the broader context of anti-avoidance. Helpfully, the Tax Avoidance Schemes (Prescribed Description of Arrangements) Regulations 2006, Reg 19(9) provides that such an inclusion would not, of itself, cause the debt security to fall foul of the DOTAS (disclosure of tax avoidance schemes) financial product hallmark.

Conversions of securities

Broadly, for capital gains tax purposes, a conversion of securities should be treated as a tax-neutral reorganisation. The relevant statutory provision (s 132) provides that the share capital reorganisation provisions (s 127 to s 131) apply to the conversion of securities in the same way as they would on a share capital reorganisation 'with any necessary adaptations'.

Without going into the detail (on which there is much academic debate), for these purposes 'securities' would typically include any loan stock or other equivalent debt instrument issued by a company, but not shares. Generally, QCBs and non-QCBs would be regarded as securities.

Therefore, the normal capital gains tax rule is that where securities are converted there is neither a disposal of the original securities nor an acquisition of the new holding. Instead, any inherent gain in the original securities at the time of conversion is rolled over into the new holding. Normally, this would be taxed on a subsequent disposal of the new holding (subject to any relief). This is achieved through the 'no disposal/no acquisition' fiction that treats the taxpayer's tax basis in the new holding as equal to that in the original securities.

A 'conversion of securities' for these purposes includes:

- a conversion of securities of a company into shares in the same company;
- a conversion of a non-QCB into a QCB issued by the same company;
- a conversion of a QCB into a non-QCB issued by the same company;
- a conversion of securities at the option of the holder as an alternative to cash redemption; and
- an exchange of securities as part of a compulsory acquisition.

As we have seen, gains arising on a straightforward disposal of QCBs are exempt from capital gains tax. Therefore, as shown by ***Cunning Plan***, and without anything more, it would be possible to convert chargeable securities (say non-QCBs) into QCBs, rely on the tax neutrality of the reorganisation provisions to avoid any capital gains tax charge on the inherent gain at the time of conversion, and subsequently dispose of the QCBs with no such tax charge because they are exempt.

For this reason, where applicable, s 116 provides that a conversion of chargeable securities (including non-QCBs) into QCBs creates a deemed gain for capital gains tax purposes. However, this is calculated by reference to the market value at conversion and is not immediately payable. Instead, it is frozen and becomes payable when the QCB is disposed of. See ***Practical Plan***.

CUNNING PLAN

Imran holds £100,000 of loan stock in Company B, the terms of which allow redemption in US dollars. The loan stock has a market value of £150,000. Because the loan stock is a non-QCB, if Imran were to dispose of it at its £150,000 market value, the £50,000 gain (ignoring any reliefs) would be subject to capital gains tax. However, if the US dollar redemption provision was removed before disposal, the loan stock (non-QCB) would become a QCB. If Imran then disposed of the loan stock for £150,000, the £50,000 gain would be exempt from capital gains tax.

PRACTICAL PLAN

Taking the previous example, let's say Imran held the loan stock for a few more years after conversion to a QCB and eventually disposed of it for £250,000. On that disposal, Imran would be subject to capital gains tax on the previously frozen gain: £50,000 – being the £150,000 market value at conversion less £100,000. However, he would not be subject to capital gains tax on the £100,000 increase in value since the conversion – the £250,000 disposal proceeds less the £150,000 market value at conversion.

The outcome in ***Practical Plan*** mirrors that in reorganisations involving QCBs and non-QCBs. For instance, take share acquisitions:

- if a shareholder sells shares for cash and QCBs, any gain attributable to the QCB element of the consideration is frozen and becomes payable on disposal of the QCB;
- if a shareholder sells shares for cash and non-QCBs, any gain attributable to the non-QCB element of the consideration may be rolled over into that non-QCB.

So, we can summarise the position as follows.

- *Non-QCBs or shares converted into non-QCBs or shares*. The conversion is not treated as involving any disposal of the original non-QCBs or shares. Any inherent gain (or loss) on conversion is rolled over into the new non-QCBs or shares.
- *Non-QCBs or shares converted into QCBs*. At conversion, the non-QCBs or shares are deemed to have been disposed of at market value. Any deemed gain (or loss) is frozen until disposal of the QCBs.
- *QCBs converted into non-QCBs or shares*. Because QCBs are exempt assets, no gain (or loss) arises on their conversion. A gain or loss will arise on the later disposal of the non-QCBs or shares.

The *Hancock* case

So with that background, we arrive at *Hancock and another v CRC*.

Mr and Mrs Hancock together owned Blubeckers Ltd which, in August 2000, they sold to Lionheart Holdings Limited for loan notes (the consideration loan notes), with possible additional consideration depending on the subsequent performance of the business – in other words, an earn-out. The Hancocks could require the consideration loan notes to be repaid in US dollars and therefore the loan notes were non-QCBs.

The subsequent events were as follows.

- In March 2001, the earn-out requirements were satisfied and Lionheart issued further loan notes with US dollar optional repayment provisions (the 'earn-out loan notes') to the Hancocks which, accordingly, were also non-QCBs.
- In October 2002, the US dollar repayment right was removed from the earn-out loan notes (but not the consideration loan notes). Accordingly, the earn-out loan notes became QCBs.
- In May 2003, pursuant to a single document, the consideration loan notes (non-QCBs) and the earn-out loan notes (QCBs) were exchanged for two sterling-denominated secured discounted loan notes (SDLNs). The SDLNs were QCBs. Each SDLN was issued to each of the Hancocks in their aggregate amounts, without separately identifying the amounts attributable to the consideration loan notes and the earn-out loan notes.
- In June 2003, the SDLNs were redeemed for cash, together with the payment of the associated redemption premium.

The issue

In short, the Hancocks were seeking to roll over the gain on the sale of Blubeckers into exempt QCBs and so avoid a capital gains tax charge, as follows:

- *Blubeckers disposal*. Because the consideration loan notes were non-QCBs, the gain arising on the share disposal was rolled over into them (so no capital gains tax was payable).
- *Earn-out*. The earn out right was itself a security and when the earn out was satisfied it was converted into the earn-out loan notes. As these were non-QCB loan notes the inherent gain was rolled over and no capital gains tax was payable.
- *2002 conversion*. Because the conversion resulted in the earn-out loan notes becoming QCBs, the inherent gain in those notes at conversion was frozen, and would become payable upon their disposal (so no capital gains tax was payable).
- *SDLN conversion*. The aim was that the SDLN conversion did not fall within the scope of s 116, with the result that the consideration loan notes and the earn-out loan notes were converted into QCBs without creating any held over capital gains tax charge.
- *SDLN redemption*. Because the SDLNs were QCBs, no capital gains tax arose on their redemption.

The SDLN conversion

The crux of the scheme turned on the SDLN conversion. The position advanced on behalf of the Hancocks was that:

- the SDLN conversion in May 2003 formed part of a wider commercial settlement between the Hancocks and Lionheart with the result that it was reasonable to treat it as a single transaction, not two separate ones (in other words, not a separate conversion of the consideration loan notes on the one hand and the earn-out loan notes, on the other); and
- s 116 could not apply to that single transaction because it did not fall within the scope of s 116(1)(b) because neither limb of that section (reproduced below) was met.

The separate limbs of s 116(1)(b) are that 'either [1] the original shares would consist of or include a qualifying corporate bond, and the new holding would not or [2] the original shares would not and the new holding would consist of or include such a bond.'

So the first limb could not apply because the new holding (the SDLNs) included QCBs, and the second limb could not apply because the original holding included QCBs (the earn-out loan notes).

Accordingly, it was argued that s 116 did not apply to the SDLN conversion with the result that the inherent gain was rolled over into an exempt asset (being the SDLNs) and that gain would not become payable on redemption of the exempt SDLNs.

HMRC, however, argued that the SDLN conversion should be treated as two separate transactions, and that to treat the SDLN conversion as a single transaction would defeat the purpose of the statutory framework.

The judgment

The Court of Appeal dismissed the Hancocks' appeal.

The first question to consider was whether the transaction, being the SDLN conversion, fell within the reorganisation provisions at s 127 to s 131. Although at first blush those provisions did not apply, they applied indirectly '*with any necessary adaptations*' by virtue of s 132.

A conversion can include both taxable and exempt securities because the original holding (in other words the security being converted) could be a capital gains tax-exempt QCB, while reorganisations can involve only taxable assets as the original holding (because the assets being reorganised could not be capital gains tax-exempt).

Therefore, in the case of a reorganisation, the court considered that there was no difficulty in aggregating different classes of shares when determining an original holding because this could only comprise taxable assets. However, if the original holding includes both taxable and exempt securities (such as QCBs and non-QCBs), the court's view was that any conversion of that original holding should be partitioned into separate conversions. According to Floyd LJ:

> 'It makes perfect sense to speak of each asset being involved in its own conversion rather than both assets being involved in an overall conversion.'

Floyd LJ also pointed out that the (non-exhaustive) list of conversions to which s 132 was intended to apply as provided in that section did not contain any conversions of mixed assets. The separation of conversions (in the case of mixed assets) seemed to Floyd LJ to constitute a 'necessary adaptation'.

Applying a purposive approach to the relevant statutory provision, Floyd LJ further considered that such an approach was justified. The result of separating conversions of QCBs and non-QCBs because of their different capital gains tax status meant s 116 could still apply. In the court's view, to allow s 116(1)(b) to upset the statutory scheme as argued by the Hancocks would result in an interpretation of the statutory scheme contrary to its overall purpose:

> 'To accept the taxpayer's construction exposes a far greater anomaly, namely that by the simple expedient of structuring a transaction which mixes QCBs and non-QCBs in any proportion, chargeable gains on non-QCBs escape capital gains tax altogether.'

This, said Floyd LJ, would defeat the policy and purposes of TCGA 1992. Indeed, if the proportion of the original holding mixed the value of QCBs and non-QCBs 1:999, the result might be considered anomalous by many commentators.

An unexpected outcome?

As for many other recent cases, the outcome depended on the Court of Appeal applying a purposive interpretation and, therefore, the *Hancock* decision is perhaps unsurprising. The scheme used by the Hancocks relied on a perceived technical shortcoming in the legislation to bring about an outcome considered at odds with the purported principles generally understood to underpin the taxation of QCBs and non-QCBs.

But, taking one line of Floyd LJ's reasoning, is it correct to say that the statutory framework did not envisage mixed conversions? For instance, the s 132 non-exhaustive list includes a conversion of 'securities' into shares and, as we have seen, both QCBs and non-QCBs may constitute securities for these purposes (see s 132(3)(a)(i)). Further, as mentioned above, s 116(1)(b) itself applies s 116 specifically when either the original holding or the new holding (although, not both) 'includes' QCBs. Surely this implies that mixed conversions (in other words, conversions including holdings of both QCBs and something else) must have been envisaged?

Leaving aside the technical position, taxpayer certainty (often overlooked) is important. Ideally, a taxpayer's liability is ascertained from the clear words contained in the legislation and should not rely on divining the underlying intention of the draftsmen at the time those words were drafted – often decades earlier.

Was Floyd LJ correct that the separation of conversions was a 'necessary adaptation'? And what is a 'necessary adaptation'? Advisers may be forgiven for previously assuming that a 'necessary adaptation' is one that allows legislation drafted to cater for one set of facts to operate notwithstanding the existence of a different set of facts and not, as Lewison LJ claimed in his judgment, an adaptation to give effect to parliament's intention; an adaptation which, as we have seen, the courts will make anyway when applying the legislation.

Testing times

These are certainly testing times to be a tax practitioner. *Hancock* highlights two principal points.

(1) The technical complexity of the reorganisation provisions generally and how they apply to QCBs and non-QCBs specifically. Although the principles may be understood, practical application can be challenging. Care should be taken whenever using QCBs and non-QCBs and consideration must be given to anti-avoidance provisions such as DOTAS and the transaction in securities rules.
(2) It is no longer enough for tax practitioners to be technical experts; they must have an understanding of wider policy objectives. Notwithstanding the apparent clarity of the legislation, a literal interpretation may not suffice if the literal outcome is contrary to the purported purposes of the rules.

In short, the tax treatment of QCBs has become slightly less certain with the court's complex interpretation of the conversions rules which call into question, among other things, the meaning of 'necessary adaptation'. Holders of QCBs obtained in a conversion may not LOL (laugh out loud) when they are told of the decision.

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