Hancock's half-decent argument

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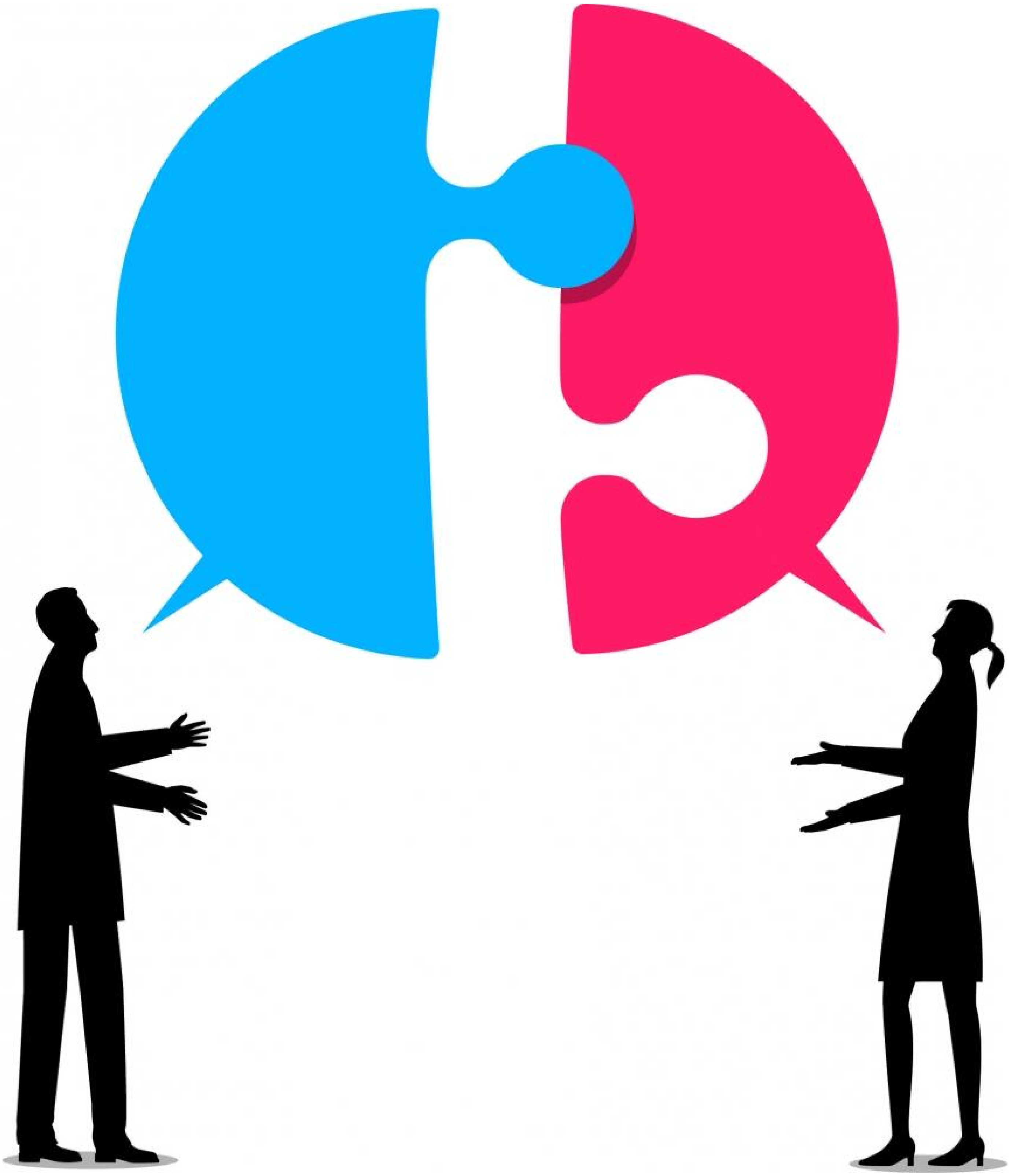

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Keith Gordon discusses the Supreme Court’s decision on the disposal of QCBs in *Hancock v HMRC*

Key Points

What is the issue?

The Supreme Court was to determine the correct capital gains tax treatment in relation to a disposal of qualifying corporate bonds which had been obtained in the course of a company reorganisation.

What does it mean to me?

Ambiguities are bound to arise on the interpretation of statutory tax code. Even if the legislation, applied literally, supports one particular outcome, the courts will not always reach the same result, particularly if tax avoidance is suspected.

What can I take away?

Of the many arrangements seeking to exploit or avoid the consequences of the special rules for QCBs, the Hancock decision means that some will now inevitably fail.

Writing about tax is a wonderful hobby. I have friends all over the country – none in HMRC perhaps, but friends elsewhere all over the country. I try not to alienate anyone when writing, of course, and I recognise that HMRC officers are tasked with a difficult job with far too few resources. However, if constructive criticism upsets individuals, then so be it. The country’s tax system will hang together only when trust is restored between taxpayers, advisers and HMRC; thus when one party’s conduct falls below acceptable standards, this spells danger for the integrity of the whole regime.

Another area where trust is paramount is in relation to taxpayers’ ability to rely with certainty on the statutory code which, after all, underpins the entire tax system. However, it is perhaps inevitable that ambiguities will arise, which is why we have an independent judiciary to interpret the rules in specific cases when disputes arise. It was in the course of such a dispute that the case of *Hancock and another v HMRC* [2019] UKSC 24 reached the Supreme Court.

The facts of the case

Mr and Mrs Hancock owned between them the entire share capital of a company, Blubeckers Ltd. On 24 August 2000, they sold these shares to another company, Lionheart Holdings Ltd. The consideration for the sale was loan notes, together with a provision for further consideration depending on the company's subsequent performance.

Two types of loan note were initially issued, the majority being classed as 'B Notes'. These carried the right to interest and were repayable on 24 August 2004. The notes provided that Mr and Mrs Hancock could require repayment of the notes in US dollars, at the spot rate available 20 days before repayment. Because of this provision for payment in a foreign currency, it was accepted that the B Notes were not qualifying corporate bonds (QCBs) for the purposes of the Taxation of Chargeable Gains Act (TCGA) 1992 s 117.

Further consideration became payable to the Hancocks on 22 March 2001, which was received in the form of further B Notes. These additional notes were subsequently revised in October 2002, so as to remove the prospect of repayment in US dollars. Accordingly, those additional notes did become QCBs.

In May 2003, the original B Notes and the later revised B Notes were exchanged for further loan notes which were QCBs. These QCBs were eventually redeemed in June 2003. The question for the court was to determine the correct capital gains tax treatment in relation to the June 2003 disposal.

The legal background

Most of the legal background was not in dispute. For example, ordinarily the share and security reorganisation rules operate so as to allow old holdings to be replaced without any immediate capital gains event arising (TCGA 1992 ss 127 to 132).

Thus, ignoring the fuller facts of this case, it might have been unnecessary to consider any of the intermediate transactions prior to June 2003. Furthermore, it was agreed that the disposal of QCBs (as took place in June 2003) would not usually give rise to any capital gains tax liability (TCGA 1992 s 115).

However, in the present case the QCBs had been obtained (in May 2003) in the course of a reorganisation. Accordingly, it was necessary to determine whether the specific rules applying to reorganisations involving QCBs (s 116) were engaged. If so, any capital gain arising on the reorganisation itself would be treated as having been frozen, only to crystallise on the final disposal of the resulting QCBs the following month.

This turned on whether s 116(1)(b) applied to the May reorganisation. If it did, then the gain frozen in May 2003 would have become chargeable in June 2003. Otherwise, the ordinary exemption for QCBs (s 115) would apply. Section 116(1)(b) would apply if 'the original shares would not [consist of or include a qualifying corporate bond] and the new holding would consist of or include such a bond'.

It was not disputed that the new holding consisted of a QCB; the question was whether the original shares 'consist[ed] of or include[d]' such a bond.

Although shares may (sometimes) be treated as individual assets, it is clear that s 116 permits a more holistic approach. Therefore, it was argued by Mr and Mrs Hancock that the original shareholding did include a QCB (being the revised notes arising from the additional consideration received in March 2001), alongside the element that clearly did not consist of a QCB (being the original notes acquired in 2000).

Accordingly, the Hancocks argued, s 116(1)(b) was not satisfied and, therefore, the only relevant provision was s 115, which exempted the entire disposal.

The Hancocks were successful before the First-tier Tribunal. Furthermore, the First-tier Tribunal rejected HMRC's attack on the arrangements themselves by which HMRC sought to apply what is generally (even if unhelpfully) known as the *Ramsay* approach to statutory interpretation in the context of 'avoidance' arrangements.

On HMRC's appeal to the Upper Tribunal, the *Ramsay* approach was again rejected. However, the Upper Tribunal allowed HMRC's appeal on the basis that there were essentially two transactions in May 2003: the conversion of the original B Notes (non-QCBs) into QCBs; and the conversion of the revised B Notes (QCBs) into other QCBs.

The Court of Appeal took the same approach. Essentially, the view taken meant that the words ‘or include’ were to be ignored. Thus, on one part of the transaction the old shareholding consisted of a QCB (and therefore s 116 did not apply); however, on the greater part, the old shareholding did not consist of a QCB and therefore s 116 did apply to that.

The Hancocks appealed to the Supreme Court.

The court’s decision

The court gave a single judgment prepared by Lady Arden, with whom Lords Reed, Sumption, Carnwath and Briggs agreed).

Lady Arden recognised the force of the taxpayers’ argument. The use of the words ‘or include’ (which have remained unchanged since the legislation was first introduced in 1984) strongly pointed to the legislation accepting that a single transaction could involve the conversion of two different types of share or security, only one of which was a QCB.

However, Lady Arden felt, on balance, that the result being sought by the Hancocks was contrary to the clear purpose of the legislation. Therefore, the court applied a more purposive approach which amounted to omitting these words.

The Hancocks’ appeal was therefore dismissed.

What to do next

There have been many arrangements in recent years seeking to exploit or avoid the consequences of the special rules for QCBs. The *Hancock* decision will mean that some will now inevitably fail. However, the case also shows that even if the legislation, when applied literally, supports one particular outcome, the courts will not always reach that result, particularly if the presence of suspected tax avoidance is perceived.

Commentary

I must admit to having some reservations about the outcome of this case. I do not doubt that a sensible result was reached; however, as the aphorism ‘hard cases make bad law’ recognises, straining legislation to give what seems to be the right result in one case risks the wrong result being reached in many other cases.

This case was decided on a ‘purposive’ approach to the legislation, although Lady Arden also referred to another tool in statutory interpretation, being to give the legislation a ‘rectifying construction’. That is simply for the courts to ‘rewrite’ a statutory provision so as to give it the reading which it is considered was meant all along. In the present case, such a rectification would have amounted to striking out the words ‘or include’ as if they just did not exist.

From my perspective, rectifying constructions in the context of tax statutes are a cause of concern if they are to be used in favour of HMRC over taxpayers. After all, as was acknowledged by the House of Lords in *Ramsay* itself, ‘a subject is only to be taxed upon clear words, not upon intendment or upon the equity of an Act’.

In the end, Lady Arden did not go so far as to do that (although she did not rule out rectifying constructions being used against taxpayers) because she felt that the right result could be obtained using the more conventional approach of purposive interpretation. In doing so, Lady Arden acknowledged the ‘clear words’ principle by noting that the rules concerning securities (s 132) applied to the reorganisations code (ss 127 to 131) ‘with any necessary adaptations’. Therefore, whilst the reorganisations code envisages a single transaction, the presence of securities was held to permit a different outcome.

With respect to the court, I must say that I am not persuaded. After all, s 132 refers only to ‘necessary’ adaptations. But for the special rules in s 116, I do not see how the single transaction approach to ss 127 to 131 needs to be modified just because one element of the transaction involves a security. On the other hand, if the Supreme Court was right, then the similar wording in s 135(3) (which applies the reorganisation rules in cases of share exchanges) means that one can dissect all sorts of corporate transactions.

It is inevitable that the legislation, when drafted, cannot envisage every possible factual circumstance. Accordingly, there will always be an element of give and take when it comes to applying the law to a particular set of facts. Such an approach is necessary to ensure that the ‘correct’ amount of tax is raised to help the country. I don’t mind giving (and/or taking) a reasonable amount, but certainty is equally important and, beyond a *de minimis* amount of flexibility, giving any more is potentially harmful.

Editor’s note: The arrangements in this case were said in the Upper Tribunal to involve a capital gains tax saving of £830,000 by these taxpayers and £3.5m in total when considering other scheme users.