Policing the boundary

Large Corporate OMB Personal tax

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Andrew Roycroft considers the impact on QCBs as a result of the recent case of Trigg

Key Points

What is the issue?

The First-tier Tribunal has decided that, contrary to a widely held view, a loan note with a euro conversion clause is a QCB

What does it mean for me?

Advisers should look at what loan notes have been issued and, if future ones are to be issued as non-QCBs, consider how this arrangement should be structured

What can I take away?

Deciding whether to use QCBs or non-QCBs may not be clear-cut; even once that decision has been taken, it may not be straightforward to ensure that the loan note satisfies the right conditions

For individuals, the distinction between corporate bonds that are qualifying corporate bonds (QCBs) and those that are not can be crucial. The latter assets are within the capital gains tax (CGT) regime, whereas gains on the former are not subject to CGT.

Corporate bonds are often issued on a takeover and over the years the preference for receiving a QCB or a non-QCB has altered according to other aspects of the capital gains regime. When taper relief existed, usually the preference was to acquire non-QCBs. This extended the holding period of an asset in order to qualify for the lower rates of tax available for assets owned for longer periods.

With the advent of entrepreneurs' relief (ER) came an initial revival in the popularity of QCBs, particularly for selling shareholders who, after a takeover, were unable to maintain the 5% minimum shareholding required for ER. Since June 2010, the position has become more balanced, with a marginal preference for non-QCBs because there is no relief from taxation for a QCB that is not paid out in full. However, there are ways to avoid such a 'dry' tax charge.

Despite the importance of this distinction, the dividing line can be a fine one.

Why distinguish between different types of corporate debt held by individuals?

The starting point in understanding this distinction is the policy decision to exempt certain corporate bonds from CGT (TCGA 1992 s 115), which was introduced in 1984 to stimulate the market. Originally, the exemption was confined to bonds issued by UK companies, but now it is available for any sterling-denominated security which represents (and has always represented) a ‘normal commercial loan’ (TCGA 1992 s 117(1)(a)–(b). This policy objective can conflict with the objectives of other aspects of the UK’s tax legislation, giving rise to difficulties and, in some cases, avoidance.

In the case of QCBs, there is a tension with the principle that individuals generally should not incur CGT when they exchange shares or securities in a company for other shares or securities, such as during a takeover (TCGA 1992 ss 127 and 135). TCGA 1992 s 116 deals with such situations by providing for the gain that would otherwise have accrued to be held over until the QCB is disposed of (typically, on redemption).

Another boundary issue concerns what might be termed ‘equity-like’ returns and foreign exchange gains. The exemption does not take such gains outside the scope of capital gains tax; it is limited to ‘normal commercial loans’ which are denominated in sterling and contain no provision for redemption in any other currency.

Attempts to make chargeable gains ‘disappear’ and to ‘create’ allowable losses

In recent years, there have been attempts to exploit these boundaries.

One series of cases involved taxpayers – such as *Harding v HMRC* [2008] STC 3499 and *Klincke v HMRC* [2010] STC 2032 – who initially rolled over gains into non-QCBs. Subsequent attempts to escape taxation in respect of that deferred gain involved those bonds becoming QCBs before redemption. Neither attempt was successful; in *Harding*, the lapse of a foreign currency conversion provision did not prevent the bond from becoming a QCB; in *Klincke*, the removal of a similar provision was a ‘conversion’ within section TCGA 1992 s 132 resulting in the creation of a held-over gain which was triggered on the redemption of the bonds.

In *Blumenthal v HMRC* [2012] SFTD 1264, the taxpayer sought to use the argument from Klincke against HMRC to create an allowable loss by rolling over a gain into a non-QCB and then artificially reducing its value just before it was converted into a QCB. The taxpayer lost, this time because the attempt to reduce the value of the bonds had failed.

More recently, in *Hancock v HMRC* [2014] SFTD 1163, the First-tier Tribunal (FTT) agreed that part of the gain on the disposal of the taxpayer's shares did escape taxation. Here, the shares were exchanged for a combination of QCBs and non-QCBs; the subsequent exchange of that combined holding for a discounted note (a QCB) did not trigger TCGA 1992 s 116 in respect of the gain that had been rolled over into the non-QCBs. Accordingly, when the discounted note was redeemed that gain never fell back into charge to tax. This decision turned on the wording of TCGA 1992 s 116(1) and is a rare example of this type of tax planning being successful.

Implications for deferral planning

Less controversially, on a takeover, shareholders will seek to preserve their tax reliefs, typically by acquiring non-QCBs rather than QCBs.

There are several methods of creating a bond which does not qualify as a QCB. It could carry rights to acquire further shares or securities; usually a right to acquire more bonds. This relies on the bond not being a 'normal commercial loan' but, because this can have adverse implications for the issuer (both interest deductibility and membership of tax groups), it is more common to include a provision for conversion into a foreign currency.

A bond must meet several conditions to be a QCB in the hands of an individual:

- the bond must have been issued after 13 March 1984 (although those issued earlier can become QCBs in some circumstances);
- it must be a security within TCGA 1992 s 132(3)(b);
- it must be expressed in sterling and not an amount that falls to be determined by reference to the value at any time of any other currency or asset;
- it must not contain provision for conversion into or redemption in a currency other than sterling (unless redemption is at the rate of exchange prevailing at

redemption); and

- it must be a ‘normal commercial loan’, within CTA 2010 s 162, which requires the bond not to carry any of the following rights:
  - convertibility into shares or securities (there is an exception for certain rights where the parent is quoted),
  - to acquire shares or securities,
  - to interest which is either ‘profit-dependent’ (again, there are exceptions; in particular for arrangements where the interest falls as profitability improves, and vice versa) or exceeds a reasonable commercial return, or
  - to an amount on redemption which exceeds the amount lent or is not reasonably comparable with certain listed securities.

In addition, certain other (limited) categories of asset are treated as QCBs. Deeply discounted securities within ITTOIA 2005 Pt 4 Ch 8 are automatically QCBs, for example.

In either case, there can be tension with the commercial objectives. This can lead to provisions which, in another context, might be viewed as artificial. For example, any right to acquire further bonds might be on unattractive terms, and those that contain a foreign currency conversion provision typically restrict forex exposure by allowing conversion only shortly before redemption and within only a narrow range of currency fluctuations (both a cap and a collar being a typical feature of such clauses). Any doubts about the efficacy of such arrangements have been dispelled by the tax tribunals, which have accepted them even where the conversion option ‘is inserted solely to ensure that the tax status of the loan note was that of a NQCB’.

An issue that has troubled advisers over the years is whether a provision for the bonds to be redenominated in euros if the UK joins the eurozone automatically causes a bond to be a non-QCB. HMRC take the view that it does, but there were differences of opinion among advisers. It is worth noting that there was no need for corporate bonds expressly to provide for such redenomination because, if the UK were to adopt the euro, this would be catered for in the enabling legislation; this would specify how sterling-denominated documents should be interpreted after the replacement of sterling.

The latest decision – provisions for redemption in euros

For the first time, the FTT has considered this issue – in the lead case of *Trigg v HMRC* [2014] UKFTT 967. The taxpayer had invested in a partnership that purchased second-hand bonds. He wanted the notes to be QCBs so that the profit he made on the subsequent disposal of those bonds would be exempt from CGT. The tribunal had to decide three issues. The first two concerned whether the euro redenomination provisions were, as HMRC argued, provisions for ‘conversion into, or redemption in, a currency other than sterling’ (within TCGA 1992 s 117(1)(b)). Even if they were, the third issue was whether TCGA 1992 s 117(2)(b) (provision for redemption only at the rate of exchange prevailing at the time of redemption) preserved the QCB status of the bonds.

The tribunal rejected the taxpayer’s argument that the references in s 117(1)(b) to sterling include the lawful currency of the UK from time to time, but agreed that neither redenomination clause provided for conversion into a currency ‘other than sterling’ because that required that the currency continued to exist separate from that into which the bonds converted. The tribunal also decided that QCB status was preserved by s 117(2)(b), although the analysis here did not fully address HMRC’s argument that s 117(2)(b) only mentions ‘redemption’ provisions; arguably, it does not protect the QCB status of bonds which convert before redemption so that interest becomes payable in another currency.

The decision is an interesting one, relying heavily on a ‘purposive’ construction of the QCB legislation. Other tribunals, notably in *Hancock*, have resisted such an approach. There are several lessons to be drawn from this. Perhaps importantly, it reinforces the importance of not relying only on a euro redenomination clause to establish that a loan note is not a QCB. Supplementing such a provision with another foreign currency conversion provision (even if restricted by cap and collar) is usually advisable; the tribunal’s decision means that HMRC might be forced to reconsider their publicly stated position. Second, it could prevent loans that were always intended to be QCBs inadvertently losing value by the insertion of euro redenomination clauses. However, it seems unlikely that such clauses will have gone unnoticed by advisers, given that HMRC’s views on the subject were well known.