COURT OF SESSION (FIRST DIVISION OF INNER HOUSE)—3 JULY AND 26 SEPTEMBER 2003 A

HOUSE OF LORDS—12 AND 13 OCTOBER AND 25 NOVEMBER 2004

Commissioners of Inland Revenue *v.* Scottish Provident Institution ([1]) B

Corporation tax—Cross options in respect of gilts—Collateral amount— Ramsay *principle—Whether options self-cancelling—Whether single composite transaction with no commercial purpose other than tax avoidance—Whether commercially irrelevant contingency prevented finding of single composite transaction—Whether appropriate to compute profit and loss in respect of each option on a mark to market basis—Whether each option a qualifying contract—Whether appropriate to attach a nil value to each option on morning of 1 April 1996—Whether appropriate to exclude collateral amount from computation—Debt contracts—Interpretation of deeming provisions—Finance Act 1994, ss 147A, 150A, 154, 155, 156 and 177(2), Finance Act 1996, Sch 15, para 25.* C D

In June 1995 a mutual life assurance company (SPI) granted to a bank (C) a call option (option A) in respect of £100 million of gilts at a strike price of 70 per cent. of the par value of the gilts. At the same time, C granted to SPI a similar call option (option B) to acquire £100 million of the same gilts at a strike price of 90 per cent. of the par value. Both options were exercisable at any time between 30 August 1995 and 1 April 1996. The premium payable by C for option A was £29,750,000 and the premium payable by SPI for option B was £9,810,000. Both sums were payable on 5 July 1995. E F

SPI and C also entered into an agreement under which SPI would pay approximately £20 million (the collateral amount) to C on 5 July 1995. This sum was repayable by 1 April 1996 or, if earlier, when option A was exercised. In a subsequent exchange of letters, SPI and C further agreed that, if both options were to be exercised on 1 April 1996, stock deliveries and all sums due to each other would be netted off. Both options were exercised on 1 April 1996. Apart from an initial structuring fee of £60,000 paid by SPI to C on 5 July 1995, the net result was that no stock or money was in fact exchanged. G

SPI appealed against an assessment to corporation tax for the period ended 31 December 1996, claiming that it had made a loss of £20 million on the basis that the premium of £29,750,000 paid by C did not fall to be taken into account in determining SPI's assessable profits because it was not a qualifying payment for the purposes of s 155 of the Finance Act 1994. H

The Crown contended, among other things, that there was a single composite transaction having no purpose other than the securing of a tax advantage, that the options and the agreement in respect of the collateral amount were self-cancelling, and that the principle laid down in *W T Ramsay Ltd.* v. *Commissioners of Inland Revenue* [1982] AC 300 therefore applied. I

([1]) [2003] Scot CS 188; [2003] STC 1035; [2004] UKHL 52; [2005] STC 15.

A The Special Commissioners rejected all of the Crown's contentions and allowed the appeal. They found that the two options were not self-cancelling as there was a genuine practical likelihood or a genuine commercial possibility that SPI would not exercise option B and that the options should therefore be accounted for as separate assets. Moreover, since SPI was entitled to rights and subject to duties under the options before and on 1 April 1996, it was deemed B under s 147A(2) to have become entitled to rights or subject to duties on that day. The options were therefore qualifying contracts by virtue of s 147A(1), and under ss 147A(2) and 155(7) the contracts were deemed to have become held on 1 April 1996 with an assumed value of nil at the beginning of 1 April 1996. The Crown appealed.

C *Held,* by the First Division of the Inner House of the Court of Session, in refusing the appeal by the Crown, that:—

(1) s 155(2) of the Finance Act 1994 employed a legal concept and created an artificial framework which did not require "loss" to be given a commercial meaning; s 155 was concerned with the profit or loss by reference to a particular qualifying contract and a particular accounting period and did not address the D setting off of a profit on one qualifying contract against a loss on another, or *vice versa*; *MacNiven* v. *Westmoreland Investments Ltd.* [2003] AC 311 applied;

(2) even if the concept of "loss" in s 155(2) fell to be treated as a commercial concept, the Special Commissioners, on the basis of their findings in fact that there was a genuine commercial possibility and a real practical likelihood that E the options would be dealt with separately and option B might not be exercised, were correct in holding that the two options should be treated separately for tax purposes; according to the Special Commissioners' findings, option B hedged the risk relating to option A; it followed that it was not an essential part of the scheme that option B would be exercised at the same time as option A;

F (3) the exchange of letters on 20 and 28 March 1996 did not have the effect of varying the agreement between the parties under the two options; as at 1 April 1996 each party still held rights or was subject to duties under the options;

(4) the terms of s 147A(2) and s 177(2)—which both referred to a party becoming entitled to rights or subject to duties—had to be read together; by virtue of s 155(7) a nil value fell to be allocated to each of the two options as at G 1 April 1996;

(5) the collateral amount fell to be left out of account on the basis of the findings by the Special Commissioners that it consisted of a genuine loan or at least a genuine deposit and that its purpose was to provide C with security and to remove the incentive for C to exercise option A early.

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The Crown appealed.

Held, in the House of Lords, allowing the Crown's appeal, that:—

(1) option A did not give C an "entitlement" to gilts for the purposes of s I 150A(1) of the Finance Act 1994 as the option formed part of a larger scheme which was a single composite transaction by which C's right to the gilts was

bound to be cancelled by SPI's right to the same gilts; there was therefore no qualifying contract for the purposes of s 147A(1); A

(2) although there was an uncertainty about whether the scheme would proceed to completion in that the parties had carefully chosen to fix the strike price for option B at a level which gave rise to an outside chance that the option would not be exercised, this was a commercially irrelevant contingency which the parties had deliberately included solely to enable SPI to claim that there was no composite transaction; the contingency created a real commercial risk, but one that was acceptable to the parties in the interests of the scheme; B

(3) it would destroy the value of the *Ramsay* principle of construing provisions such as s 150A(1) as referring to the effect of composite transactions if their composite effect had to be disregarded simply because the parties had deliberately included a commercially irrelevant contingency, creating an acceptable risk that the scheme might not work as planned; the composite effect of such a scheme should be considered as it was intended to operate and without regard to the possibility that, contrary to the intention and expectations of the parties, it might not work as planned; *W T Ramsay Ltd.* v. *Commissioners of Inland Revenue* [1982] AC 300 applied. C D

Craven v. *White* [1989] AC 398; (1988) 62 TC 1 distinguished.

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The Crown appealed against the following decision of the Special Commissioners dated 4 April 2002.

Decision ([1]) F

1. This is an appeal against an assessment for the period ended 31 December 1996. The only matter with which we are concerned is whether a loss of about £20 million is allowable. However, the appeal raises questions of interpretation of new rules for the taxation of bonds and gilts introduced by the Finance Act 1996, in the context of call options taken out as part of a tax saving scheme. The appeal also raises the question whether the arrangements entered into, which may yield substantial loss for tax purposes fall within the *Ramsay* approach as extended and explained by subsequent case law. The Appellants were represented by Graham Aaronson Q.C., of the English Bar, and Colin Tyre Q.C. Mr. Aaronson led the evidence of Mr. John Paterson, then senior corporate manager of the Appellant, David Woods, FIA and then Chief Executive of the Appellant, Fiona Austin, CA (nee Harrold), then Manager, Citibank and Christopher Taylor, C.A., partner PriceWaterhouseCoopers. The Respondents (the "Revenue") were represented by Gerry Moynihan Q.C. and Jane Paterson, Advocate. Mr. Moynihan led the evidence of Eugene Mitchell C.A., Inland Revenue Large Business Office advisory accountant, Christopher Russell, Fellow of the Faculty of Actuaries in Scotland, and Fellow of the Institute of Taxation, and Thomas Grimes, FIA and member of the Stock Exchange, and an expert in the Gilt Edged market. All witnesses produced and spoke to G H I

([1]) [2002] STC (SCD) 252.

A precognitions or Reports prepared and exchanged in advance of the Hearing except Mr. Taylor. He was a late addition. However, he prepared a written statement which was circulated before he gave evidence. No objection was taken to Mr. Taylor being added to the Appellant's list of witnesses or to the lateness of his precognition. Both parties lodged a substantial number of documents. They fell into two bundles. The first a joint bundle, which we shall refer to as J/ B and the second a bundle in three volumes which accompanied the Report prepared by Mr. Mitchell; we shall, where necessary, refer to this bundle as M1/ etc. There was inevitably some duplication in the documents produced. The authenticity, and where applicable the transmission and receipt, of the documents produced were not in dispute by either party. We found all witnesses generally credible and reliable. There was no cross examination or submissions C suggesting otherwise except, in relation to Fiona Austin and we consider that particular submission at para 24 below. Counsel produced skeleton arguments prior to the Hearing. A draft Statement of Agreed Facts was prepared and produced but was not signed by counsel. Counsel were unable to agree its final terms. We have therefore placed no reliance upon it although some of the facts set forth within it have found their way into our findings-of-fact. Mr. Moynihan produced written submissions which formed part of his closing address to us. Mr. D Aaronson produced written proposed findings-in-fact. The Hearing took place on 10–14 September 2001 and 18 December 2001. We shall begin by summarising the scheme, and then set out our principal findings-in-fact. Thereafter, we shall summarise the submissions, consider the scheme in more detail, outlining our views and conclusions on the evidence and arguments.

E 2. This case concerns a tax avoidance scheme relating to two options granted on 30 June 1995:

Option A. Citibank International plc (Citibank) paid £29.75 million to the Appellant for the option to acquire £100 million 8 per cent. Treasury 2000 (the gilt) at a price of 70 between 30 August 1995 and 1 April 1996;

F Option B. The Appellant paid £9.81 million to Citibank for the option to buy £100 million of the gilt at a price of 90 between 30 August 1995 and 1 April 1996.

3. The scheme was intended to work in the following way. The Appellant's hope was that under legislation which had been proposed in a consultative document on the taxation of gilts and bonds issued on 25 May 1995, the £30 G million (approximately: we shall use round figures throughout this decision), paid for the grant of Option A before the legislation came into force, would fall out of account; the receipt was not taxable under existing law because options over gilts are not liable to tax on capital gains. They hoped that when the legislation came into force and Option A was exercised the Appellant would receive £70 million and transfer out £100 million of gilts worth say par thus, it H was hoped, making a loss of £30 million. Had Option A been the only transaction, the Appellant might have had to buy the gilt at over 100, thus making a commercial loss. The purpose of Option B was to hedge the transaction and protect them from this risk. As it turned out (assuming for the moment that the Appellant is right), Option B was to the Appellant's tax disadvantage, since the mirror image of the Option A tax treatment applied with the result that it paid I £90 million to receive gilts worth £100 million and made a taxable profit of £10 million which reduced its loss to £20 million (had they known, the Appellant,

assuming their arguments are well founded, could have avoided the result by exercising Option B before 1 April 1996). A

4. There is a further component of the scheme. Had there just been the two options, Citibank would have been out of its money by £20 million, having received £10 million for Option B and paid out £30 million for Option A. Citibank would be in the position that it would want to exercise Option A at the earliest possible moment while the Appellant naturally wanted it to wait until the legislation was in force before it exercised Option A; as it turned out, the legislation came into force on the last day of the option period, 1 April 1996 (and the only reason the options extended to that day was that 31 March was a Sunday—the practice in those circumstances being to extend the option period to the next business day). This aspect was dealt with by a Collateral Agreement made on the same day as the options under which the Appellant paid £20 million by way of interest-free loan to Citibank, repayable when Option A is exercised. The difference between the two payments on the grant of the options is, in fact, £60,000 short of the £20 million, which is effectively Citibank's fee or fixed return, including any hedging costs, for entering into the arrangements built into the option figures. Finally there was a further contract made on the same date under which a success fee of up to £240,000 was payable to Citibank if the scheme succeeded. This is calculated at 10 per cent. of the difference between the value of the long term business funds of the Appellant after and before including the options contracts less the £60,000. This we understand is a way of expressing the fee as 10 per cent. of the tax saving. B C D E

Principal Findings-in-Fact

5. In the light of the evidence and documents, we found the following principal facts to be admitted or established:— F

1. The Appellants are a mutual life office incorporated by Act of Parliament. They have their group head office at Edinburgh.

2. Citibank NA ("Citibank") is an American bank with a branch registered in the UK. G

3. On or about 25 May 1995 the Inland Revenue published a consultative document entitled "The Taxation of Gilts and Bonds" [J/3]. The document concerned the reform of the tax rules for gilts and bonds. In general terms, it proposed a major simplification of the then current tax rules applicable to gilts and bonds, including derivatives such as options, by treating profits as of an income nature with losses being relievable against income. The rules for corporate holders would parallel the rules for new financial instruments in the 1994 Finance Act. Comments on the proposals were invited by 30 June 1995. H

4. On or about 20 June 1995 [J/4] Citibank proposed to the Appellants a scheme which had as its object the creation of expenses within the new proposed tax regime referred to above. The essence of the Scheme was the purchase by the Appellants from Citibank International plc of a call option at a strike price of 95 per cent. of the nominal value of the bond; and the purchase by Citibank International plc from the Appellants of a similar call option but with a strike price of about 70 per cent. of the nominal bond I

A value. A premium was to be paid for each purchase. After the commencement of the new tax regime, the options are exercised. The Appellant's loss on the sale of the Bonds is expected to be an "income loss", while the premium received for the option written by the Appellant is treated as exempt under the old tax regime. Under the new regime the premium paid by the Appellant may be added to the purchase price of the B Bonds thus reducing or eliminating the profit on the exercise by the Appellant of the option granted by Citibank.

5. The Citibank scheme was discussed at Board level by the Appellants on 27 June 1995 because it did not fall within its normal investment guidelines. The Board granted authority to its senior management to proceed with the proposed scheme giving it discretion on details and C implementation.

6. After the drafting and discussion of various documents between the Appellants and Citibank between about 22 June 1995 and 30 June 1995, four documents were executed on or about 30 June 1995.

7. The parties entered into an agreement [J/19] entitled OTC Bond Option Confirmation. They referred to this agreement as Transaction A and D gave it the reference number 1224895. It incorporated the terms of the International Swap Dealers Association 1992 Master Agreement ("ISDA") with amendments. Under Transaction A, the Appellants granted a call option to Citibank in respect of £100,000,000 of nominal amount of 8 per cent. UK Gilts due 7 December 2000 at an option strike price of 70 per cent. of the par value of the bond plus accrued interest. The option was E exercisable at any time between 30 August 1995 and 1 April 1996. The premium for the option was £29,750,000 payable to the Appellants on 5 July 1995. Provision was made for notice of exercise of the Option to be given. If the Option were to be exercised, then settlement was to be "physical" i.e. the Bonds were to be delivered in exchange for payment.

8. The parties entered into an agreement [J/18] entitled OTC Bond F Option Confirmation. They referred to this agreement as Transaction B and gave it the reference number 1224905. It incorporated the terms of the International Swap Dealers Association 1992 Master Agreement ("ISDA") with amendments. Under Transaction B, Citibank granted a call option to the Appellants in respect of £100,000,000 of nominal amount of 8 per cent. UK Gilts due 7 December 2000 at an option strike price of 90 per cent. of G the par value of the bond plus accrued interest. The option was exercisable at any time between 30 August 1995 and 1 April 1996. The premium for the option was £9,810,000 payable by the Appellants on 5 July 1995. Provision was made for notice of exercise of the Option to be given. If the Option were to be exercised then settlement was to be "physical", i.e. the Bonds were to be delivered in exchange for payment.

H 9. The ISDA, a print of which the parties signed in about November 1995 [J/23], contained a number of general provisions including a single agreement clause agreeing that the confirmation, the ISDA and a schedule thereto, also signed by the parties formed a single agreement between them. Clause 2(c) of the ISDA provided for netting the amounts due to or by either party at settlement at the election of the parties.

I 10. On or about 30 June 1995, the parties entered into an agreement [J/20] entitled "Collateral Agreement in respect of American call option;

Transaction Ref: 1224895". This is a reference to Transaction A referred to above. Under the Collateral Agreement, the Appellants required to pay Citibank on 5 July 1995 the Collateral Amount, defined as "An amount of Pounds Sterling equal to the Bond Entitlement of Transaction A multiplied by the difference between the Option Strike Price of Transaction A and the Option Strike Price of Transaction B." This amounted to £20,000,000. Under the Agreement, it fell to be repaid, without interest, on the earlier of the day on which Transaction A was exercised and 1 April 1996.

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11. The parties also entered into a further agreement on or about 30 June 1995, entitled Structuring Fee [J/22]. This entitled Citibank to a structuring fee calculated by reference to the Appellant's long term business funds including and excluding the two option contracts, less the initial fee of £60,000, and subject to a maximum of £240,000. The maximum total fee was thus £300,000. The agreement provided for payment on 1 September 1996.

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12. The Scheme, which comprised the two Option Contracts, the agreement for the deposit of collateral, and the Structuring Fee agreement were described by Mrs Austin in a Booking Summary prepared by her for middle management at Citibank on or about 3 July 1995 [J/24]. These option contracts created a genuine economic risk for Citibank. That risk was passed to Citibank, Frankfurt. Citibank, Frankfurt managed a pool of options to which the said two options were added. Citibank's bond option trading activities and risk management took place at Citibank, Frankfurt.

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13. On 5 July 1995, the sum of £60,000 was paid by the Appellants to Citibank. This was the difference between the sums payable by the Appellants to Citibank (£9,810,000 + £20,000,000 i.e. 29,810,000) and the sum payable by Citibank to the Appellants (£29,750,000).

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14. On or about 12 July 1995, the Inland Revenue issued a Press Release intimating the introduction of new rules for the taxation of gilts and capital bonds on 1 April 1996. An internal memorandum of the Appellants dated 12 July 1995 [J/28] recognised that holding the options until 1 April 1996 introduced a potential investment risk for Citibank, the risk being the possibility of the underlying gilts, being the subject of the Option contracts, falling below 90 per cent. of its nominal value i.e. below the strike price of Transaction B.

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15. By letter to Citibank dated 20 March 1996 [J/35], the Appellants intimated that in the absence of further instructions, if Citibank exercises its option under Transaction A on 1 April 1996 [a Monday], then the letter is to be treated as constituting notice by the Appellants of the exercise of its option under Transaction B on 1 April 1996. By letter in reply on or about 28 March 1996 [a Thursday] [J/36], Citibank confirmed that if both options were to be exercised on 1 April 1996, stock deliveries and all sums due (including the £20 million collateral deposit under Transaction A) would be netted off for settlement purposes, with the result that neither stock nor money would be exchanged. The letter further provided that in the absence of further instructions, if the Appellants exercised its option under Transaction B on 1 April 1996, then the letter was to constitute notice by Citibank of exercise of its option under Transaction A on 1 April 1996. The

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A terms of that letter were agreed by the Appellants on or about 28 March 1996. Neither party provided further instructions.

16. By fax letter dated 1 April 1996 to Citibank [J/37], the Appellants exercised its option under Transaction B and noted that Citibank's option under Transaction A was also thereby exercised and that settlement was agreed to be by offset. The position was confirmed by fax letter in reply by B Citibank on the same day [J/38].

17. In the course of the audit of their accounts for the year ended 31 December 1995, an error of £20 million was noted. It was attributable to a deposit for that amount with Citibank having been taken credit for twice in compiling the balance sheet at 31 December 1995. Assets were thus overstated in the year end balance sheet by £20 million. The error was C reported to the Department of Trade and Industry when the Appellants submitted their statutory returns in terms of the Insurance Companies (Accounts and Statements) Regulations 1983. The error was corrected in the following year's accounts.

18. Transactions A and B were entered into by the Appellants and Citibank acting at arm's length. The options and premia payable were D negotiated at market rates. When Transactions A and B were entered into along with the Collateral Agreement, there was a genuine commercial possibility of movement of interest rates and gilt prices such that it would be in Citibank's commercial interests to either refrain from exercising Option A or exercising or attempting to exercising it on a date different from the exercise by the Appellants of Option B. There was a genuine commercial E possibility and a real practical likelihood that the two options would be dealt with separately. Likewise, there was a genuine commercial possibility and a real practical likelihood that Option B would not be exercised by the Appellant.

19. On or about 25 October 2000, the Inland Revenue issued to the Appellants a Notice of Assessment for the period 1 January 1996 to 31 F December 1996 [J/52] to corporation tax. By letter dated 2 November 2000 [J/53], the Appellants appealed against that assessment.

20. Our more detailed findings-in-fact emerge in our consideration of the background to the scheme, whether the options are separate transactions, and mark to market.

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Background to the scheme

6. Citibank approached the Appellants, with whom they had an established relationship, with the scheme on 22 June 1995 following the Appellant's refusal to sign a confidentiality undertaking because of that relationship. The scheme H was not given to anyone else. At that time, the scheme was called a "Negative I–generating tax structure" (this being a reference to the I minus E method of taxing insurance companies), about which Mr. Moynihan made much play, and later it was called a "cross options scheme." We do not find the name material; it is admitted that it was a tax avoidance scheme. After some negotiations, during which the collateral agreement was introduced and the strike prices changed I from 65 and 95 to 70 and 90, the scheme in its final form was put to the Appellant's board on 27 June 1995 since the transactions did not fall within its

normal investment guidelines; it was approved by the Board. The options, the collateral agreement and the success fee agreement were all entered into on 30 June 1995. The option prices were based on a price for the gilt of 99.75 which was the price on the day the Appellant's Board approved the transaction. The options were entered into on commercial terms. The options created a genuine economic risk to Citibank; they passed the risk to Citibank NA (Frankfurt) who managed a pool of option contracts. The fee of £60,000 built into the option prices remained with Citibank in the UK.

7. The Appellant's investments were managed by a subsidiary, which operated in a similar manner to an external investment adviser. This transaction was not managed by the subsidiary and, in its investment records, the options were included with N/A against the valuation.

8. The options were entered into on the last day for commenting on the consultative document on gilts and bonds before the details of the legislation was known. It was then expected that the legislation would come into force during the accounting period to 31 December 1995 in which case it was likely that both options would be exercised. It was announced in July 1995 that the commencement date for companies would be deferred until 1 April 1996, the last day for exercising the options. The options were therefore unexercised on 31 December 1995 and were valued for the purposes of the 1995 accounts (Option A minus £34.875 million, Option B plus £14.875 million with the collateral deposit being plus £20 million so that the net amount was nil). Because of an error caused by the absence of values for the options in the investment summary, the asset of the collateral deposit but not the net liability of the options was included in the accounts, resulting in an overstatement of assets by £20 million. This was discovered when the Department of Trade and Industry return was made. The auditors agreed that the error was not material.

9. On 20 March 1996 Mr. Paterson of the Appellant wrote [J/35] to Citibank agreeing to net off payments and stock deliveries if both parties exercised their options. Citibank agreed in a letter, which was countersigned by Mr. Paterson on 28 March 1996 [J/36]. This agreement did not commit either party to exercise the options, although Mr. Paterson stated in his letter of 20 March that it was the Appellant's present intention to exercise Option B. There was no advance agreement that both options would be exercised on 1 April 1996, although this must have been likely by 28 March 1996. The legislation duly came into force on 1 April 1996 and both options were exercised on that day, the last day for exercise. Because of the agreement to net off the payments, no money or stock changed hands.

10. Counsel for both parties produced skeleton Notes of Argument. Mr. Moynihan, for the Revenue, produced a detailed written closing submission, which he revised in the course of his submissions, and Mr. Aaronson produced written proposed findings-in-fact. Both counsel supplemented the written material with detailed submissions on the law and the evidence. We are grateful to counsel for the wealth of material presented to us and trust that we shall be forgiven for not incorporating all of it into this decision. We have endeavoured in this part of the Decision to distil the essential features of each side's arguments. We consider what seem to us to be the critical points at issue below.

A **Submissions for the Appellant**

11. Underlying the Appellant's case was the acceptance that the purpose behind the transactions under consideration was the exploitation of detailed statutory rules to produce a statute-created loss. This could have been achieved by entering into Option A without entering into the hedging arrangement B (Option B). It was anticipated correctly that the new rules relating to "loan relationships" (which would include gilts) would borrow certain features from legislation dealing with financial instruments, the effect of which would be that payments made prior to the commencement date for the new statutory rules would be left out of account in computing profits and losses arising from loan relationships under the new regime (see also the Taxation of Chargeable Gains C Act 1992 s 115 and ICTA 1988 s 128). Thus the £30 million paid prior to the commencement of the new regime was excluded from any charge to tax. On the other hand the other elements of Option A, namely the transfer of £100 million gilts for £70 million was expressly included in the new regime and created a loss of £30 million. That all this came to pass was as a result of educated guesswork by those involved. There were various other possibilities when the Options were D entered into, which might have had very different tax consequences. The result, submitted Mr. Aaronson, was a drafting "own goal"; the draftsman had not considered the case where initial payments excluded from computation under the new rules were also excluded from tax by the old regime. This appeal was likely to be the only case where the particular own goal would lead to a win for the taxpayer. Mr. Aaronson then turned to the detail of the statutory provisions. E Chapter II of Part IV of the Finance Act 1994, as amended, has effect from 1 April 1996. Transitional provisions contained in para 25 of Sch 15 to 1996 Act were not relevant for present purposes. He submitted that a loan relationship included a gilt (1996 Act, s 81(1)); the relationship between the parties constituted a debt contract or option within s 150A of the Finance Act 1994 (subss (1) and (10)). The Appellant was a qualifying company for the purposes of Chapter II (1994 Act s 154); the payments made were qualifying payments F (1994 Act s 153(1)(ca), 150A(5), 151). Gilts are money's worth therefore a transfer of a gilt is treated as a payment (1994 Act s 150A(11)). The payment of the sum of £60,000 fell within s 150A(5)(a) or (b); it was part of the price to induce Citibank to become a party to the transactions. Even if it does not fall with s 150A it falls within s 151. In any event it or alternatively it falls to be regarded as small within s 152 of the 1994 Act. Each option fell to be treated as a separate G contract.

12. The operative part of the statutory scheme was s 155 of the 1994 Act. Section 155(4) applied (mark to market basis). The sum of £30 million fell to be left out of account; it was not a qualifying payment, having been paid before 1 April 1996. Accordingly, under the new statutory rules, a loss of some £34 H million was made because the Appellant had transferred £104 million worth of gilts (£104 being the value of the gilts on transfer) but received only £70 million of qualifying payments. Under Option B, they made a profit of £14 million; they received £104 million worth of gilts but paid only £90 million. The net loss is £20 million. Without the hedging Option B, the loss under the new statutory regime would have been greater, namely £34 million. Although the Appellant entered I into the transactions on 30 June 1995, it was deemed to have become entitled to rights or subject to duties thereunder on 1 April 1996 (1994 Act s 147A(2)). As

noted above, the sum of £60,000 fell to be included as part of the price for Option B. It included an element of hedging costs. If, contrary to his primary submission, the options fell to be treated as a single composite transaction, the statutory provisions meant that the single transaction was a debt option and the ultimate result was the same, namely a loss of £20 million. A

13. Mr. Aaronson then dealt with the deeming provisions. There were two deeming provisions, namely ss 155(7) and 147A(2) of the 1994 Act. The combined effect of s 147A(2) and (3) was that the Parliamentary draftsman failed to consider the position of a transaction that was exempt from capital gains tax. B

14. As to the evidence, Mr. Aaronson began by submitting that there was a fundamental flaw in the Revenue's whole approach to this appeal. The flaw was that, as both Mr. Mitchell and Mr. Russell stated in evidence, the scheme only worked if both options were entered into. This, he submitted, was obviously wrong. On the evidence, there were two legally separate contracts. They were accounted for separately by the Appellant, and there was evidence from Mr. Paterson that the Appellant recognised that the options might not be exercised together. He relied upon the terms of a letter dated 22 June 1995 [J/6] to Citibank from their advisers Arthur Andersen, internal Memoranda of the Appellant dated 12 July 1995 [J/28], and 9 October 1995 [M/11], and on the evidence of Mr. Paterson and Mr. Woods. This recognition was genuine and reasonable, particularly when one considered that there was no certainty what Citibank might do with their option (Option A). He also drew our attention to TCGA 1992 s 144(8)(c))(iii) which recognises that options hedging other options exist and may be taxed separately. The relevant test was not what was expected or most likely, but whether there was any realistic or genuine commercial possibility that the options might not be exercised together or would be dealt with separately. An outside chance, Mr. Aaronson submitted, was a genuine commercial possibility. Mr. Paterson stated that letting Option B lapse was regarded as a genuine possibility. Here, the test was passed having regard to the foregoing considerations. Mr. Aaronson invited us to make a series of factual findings to support this contention and other arguments. He accepted that if we held that there was no genuine commercial possibility of the Options not being exercised together, then the appeal failed. C D E F G

15. On the issue of mark to market (s 155(4) of the 1994 Act), Mr. Taylor's view, according to Mr. Aaronson, was that one should mark to market, even where netting off is carried out. Netting could not change the nature of the arrangements or the operation of the tax code. Even Mr. Mitchell, whose view was based upon the proposition that the options had to be exercised together accepted the mark to market basis as appropriate if the options were exercised separately. The policy of the Appellant was to mark to market; and this was consistent with commercial or normal accountancy practice. H

16. As to the question of the "loan" it was a collateral contract that could not be treated as part of the options contracts. It was described by the parties as a collateral deposit (see J/35 letter dated 20 March 1996 Appellant—Citibank, and J/36 letter dated 28 March 1996 Citibank/Appellant). The legislation did not contemplate such a deposit being treated as a qualifying payment. Moreover, it required separate accountancy treatment. In relation to the authorities, Mr. Aaronson referred us to the decision of the House of Lords in *MacNiven* v. I

A *Westmoreland* [2001] STC 237 and, in particular, paras 47-49, 56, 59-62. He accepted that there was no commercial loss but submitted that that did not matter because we were here dealing with a series of highly technical statutory provisions. It did not matter if the only purpose was the exploitation of a drafting blunder and the creation of a tax loss. He next referred us to *Griffin* v. *Citibank Investments Ltd.* [2000] STC 1010, especially paras 33-49 and 52-53. He B submitted that para 43 was no longer good law having been superseded by *MacNiven*. He also informed us that the Revenue were refused leave to appeal in *Griffin*. He argued that it would be wrong to say that there was no practical likelihood that the options in the instant appeal would not be exercised on the same date. Finally, he referred to the decision of Special Commissioners Cornwell-Kelly and Wallace in *HSBC Life (UK) Ltd.* v. *Stubbs* 6 November C 2001, LON/SC00295 paras 54, 71, 73, 81, and 87-89.

Submissions for the Revenue

17. Mr. Moynihan began by making submissions on the evidence. He submitted that (1) the transaction (he used the singular) had no other commercial D purpose than the securing of a tax advantage; (2) given the strike prices, there was no commercial (practical or realistic) likelihood of there being any financial consequence for either party; this was the expectation of both the Appellant and Citibank; (3) the relevant contract had to be identified for the purposes of commercial accountancy issues, the proper interpretation of the statutory provisions, and the *Ramsay* argument; the relevant contract was a single E composite transaction, or at least it became so by the relevant date, if not before; (4) there were five steps in the transaction, namely (i) Option A, (ii) Option B; (iii) the Collateral Agreement; (iv) the premium payable for Option B i.e. £9.75 million plus the initial fee of £60,000; and (v) the Structuring Fee, which was the lesser of (a) 10 per cent. of the tax saved less £60,000, or (b) the sum of £240,000; (5) the transaction itself was unique; (6) steps (i) to (iii) of the transaction were F inter-linked and were the constituent parts of the tax scheme, and (iv) and (v) were Citibank's fee for licensing its scheme to the Appellant; (7) what actually happened, i.e. both options being exercised on the same day, was the most likely outcome and what parties expected to occur; (8) steps (i) to (iii) were self-cancelling and there was no commercial purpose other than an attempt at tax avoidance in exchange for a success fee; (9) there were various inbuilt checks and balances to ensure that the options had no separate commercial value, such as G the Collateral Agreement and the reduction of the strike price from 95 to 90; (10) by 28 March 1996, if not before, the operative parts of the scheme had become indivisible and self-cancelling; an agreement was entered into on that date whereby it was agreed that if the Appellant exercised its option on 1 April 1996 both options would be exercised on that date and netting off would apply; (11) Option B was not simply a hedge; it was thought that it would produce its own H tax advantage, but this has now been conceded by the Appellant.

18. Mr. Moynihan then referred us to *Griffin, Piggott* v. *Staines Investments Co. Ltd.* [1995] STC 114 at p 134 E-H, and *MacNiven*, particularly paras 33, 34, 40, 49, 58. He submitted that we should approach matters in a commercial manner. He accepted the test could be expressed in terms of genuine I commercial possibilities. There was no justification for applying mark to market separately to the two options. It had to be established that doing so accorded

with normal accountancy practice; this requires an examination of the substance as well as the form of the transaction; the question whether there was no genuine commercial possibility of a fall in the value of the gilt to less than 90 or 70 was not considered by the Appellant's management. A

19. In relation to the Collateral Agreement, Mr. Moynihan submitted that even if the two options were qualifying contracts it was wrong to exclude the payment under the Collateral Agreement from the aggregate of qualifying payments; the Collateral amount was part of the consideration for Option A; it was part of the consideration for the debt contract and is therefore a qualifying payment. Mr. Moynihan then submitted that the fee for the proprietory tax scheme was not a debt contract; moreover, there has to be a debt contract as at 1 April 1996 for the Appellant's scheme to work. Given the agreement on 28 March 1996 to net off with the result that neither stock nor money would be exchanged it would be nonsensical to speak of any subsisting rights or duties under a debt contract or of any entitlement or duty to become a party to a loan relationship. B C

D

20. Mr. Moynihan made a number of subsidiary arguments. He submitted, in particular, that s 155(7)(a) of the 1994 Act did not apply to deemed acquisitions; deemed acquisitions fall to be entered at their market value as at midnight on 31 March 1996. He referred us to *Marshall* v. *Kerr* (1994) 67 TC 56 and *Jenks* v. *Dickinson* (1997) 69 TC 458 at pp 487-8 for the proposition that deeming provisions may be limited in effect if a literal application would produce unjust or absurd results. He attached two computations to his written submissions to demonstrate his arguments. E

Whether the options are separate transactions F

21. In relation to a series of transactions, it is well recognised that the only time they can be considered as a single transaction is when there is no practical likelihood that the events will not take place in the order ordained. As was stated by Patten J. in *Griffin* v. *Citibank Investments* [2000] STC 1010, at p 1038 this does not refer to a theoretical possibility but a genuine practical likelihood. In the words of Lord Oliver in *Craven* v. *White* [1988] STC 476, at p 503h the test is whether "the successive transactions are so indissolubly linked together, both in fact and intention, as to be properly and realistically viewed as a composite whole." We approach the question of the separate nature of the options and the collateral agreement in this light. G H

22. The combined effect of the two options is that so long as the price of the gilt is above 90 neither party makes a profit or a loss when they are both exercised; the profit on one option is always offset by the loss on the other. If the price of the gilt was below 90, the Appellant would not exercise Option B but would buy cheaper in the market and make a profit of the amount by which the price was below 90 and Citibank would make a corresponding loss. The maximum profit for the Appellant and loss for Citibank is £20 million which occurs when the price of the gilt falls to 70. The options are therefore self-cancelling if there is no practical likelihood or no genuine commercial possibility of the price falling below 90. Accordingly we examine this aspect first. I

A 23. On this point there was the following evidence. At the time of grant of the options the price of the gilt was very volatile. There had been a 4 point rise in May 1995 then a 3.5 point fall in June 1995. The price was 101.28 on 22 June 1995 and 99.06 on 29 June 1995, a fall of 2.2 points in a week. Mr. Grimes showed that a drop from 99.16, the price on 30 June 1995 when the options were granted, to 90 represented a rise in interest rates of 2.25 per cent. The chance of a change B of this magnitude occurring, based on the Financial Times 5 year gilt indices, was 0.26 per cent. (based on 1990 to 2000) to 0.45 per cent. (based on 1983 to 1990) in the 2 months during which the options could not be exercised, the latter period being in his view more relevant because of the degree of volatility in the market in May and June 1995. During the 9 month life of the options the chance was about 3 per cent. which he said might be an over-estimate. Mr. Paterson, C acknowledging that the future was unknown, said that the chances were similar to that of an outsider winning a horse race. In re-examination his assessment was 20-1 to 25-1 which was 5 per cent.–4 per cent. It is interesting that in an internal note (written on the notepaper of a subsidiary of the Appellant, Prolific Life Asset Management Ltd.) on 12 July 1995 [J/28], Mr. Simon Burke, then Group Tax Manager of the Appellant, drew to the attention of his colleagues the announcement that the legislation would come into force on 1 April 1996 and D referred as a consequence of the postponement of the expected date to the possibility of making a profit if the price dropped below 90.

24. In evaluating this aspect of the appeal, we emphasise that the price of the gilt depends on market forces, particularly interest rates, which are outside E the control of the parties. In asking the question (whether there was any practical likelihood or genuine commercial possibility of the strike price of the gilt falling below 90) we are also speculating about the future about which there can be no certainty (it is worth recalling that we were sitting during the events of 11 September 2001). The past occurrence of price movements during a 9 month period is a guide to the future but only that. It is also relevant that Citibank was F willing to enter into a transaction under which it made a loss if the price of the gilt fell below 90 but, apart from the fee built into the option price, it could never make a profit. This suggests that they did not consider that making a loss was particularly likely, although as a dealer in options they would be able to offset the liability. They regarded the £60,000 as including the cost of hedging the risk they were taking. We accept Mrs Austin's evidence to this effect; she was clear and firm on this point and we can find no reason to disbelieve her; Mr. Grimes G was of the view that the sum of £60,000 could have included a risk element; we therefore reject the Respondent's attack on her reliability. Mr. Burke's note of 12 July 1995 [J/28] showed that the possibility of making a profit was in the minds of officers of the Appellant shortly after entering into the options. Our decision, based on this evidence, is that the price falling below 90 was unlikely but not so unlikely that one could say that there was no practical likelihood of its occurring, H and accordingly that there was a genuine practical likelihood or to put it another way a genuine commercial possibility that the Appellant would not exercise Option B. We were attracted by Mr. Paterson's horse race analogy which gets away from seemingly exact figures. If the chance of the price movement occurring was similar to an outsider winning a horse race we consider that this, while it is small, is not so small that there is no reasonable or practical likelihood I of its occurring; outsiders do sometimes win horse races. It follows that there was a genuine practical likelihood or a genuine commercial possibility that the

Appellant would not exercise Option B. The result would be that the Appellant would make a profit and Citibank a loss. A

25. We consider that, while it is near the limit, this degree of uncertainty saves the transactions from being ignored for tax purposes. Mr. Moynihan tried to argue that nobody would carry out the transaction for that small possibility of profit. The Appellant admits that; they did it for tax reasons, not in any expectation of making a profit from the price of the gilt falling below 90, but the point is that they did something that had a sufficient degree of uncertainty attached to it that we cannot ignore what they did. Mr. Moynihan argued strongly that (as the Appellant admits) this is nothing but a tax avoidance scheme in which no money passed, apart from the fee of £60,000, nobody acquired any gilts, and in the end everything cancelled out as was always expected. These are serious considerations but they do not enable us to ignore the transactions. They were genuine transactions under which the parties could make a profit or loss even though the expectation was that they would not. In our assessment of the evidence, this was clearly more than a mere theoretical possibility. We can add to all this that it was, according to the evidence of Mrs Austin, which we accept, as at 30 June 1995 by no means a foregone conclusion that the proposed legislation contained in the Consultative Document [J/3] would be enacted. B C D

26. In the light of this finding, we turn to the remaining facts. There was no agreement that the options would not be exercised early. Each party was free to exercise the options if it wanted. Had Citibank done so early and deprived the Appellant of the opportunity of making a tax loss there was no obligation on it to return the fee built into the price. Although it might appear that Citibank would exercise Option A if the price approached 90 in order to force the Appellant to exercise Option B and thereby prevent Citibank from making a loss, it did not follow that the Appellant would exercise Option B if Option A was exercised. It was possible that Citibank would exercise Option A without the Appellant exercising Option B, even though that would leave the Appellant immediately out of pocket because it would have to buy in the market above 90, perhaps because the price was close to 90 when that option would have significant time value. In any case, Option A was held in an options pool, and it would not be looked at by Citibank in isolation. It was unlikely that the Appellant would exercise Option B (which necessarily means that the price would be above 90) without Citibank exercising Option A. If by 1 April 1996 the price was below 90 (but above 70) it is certain that Citibank would have exercised Option A and the Appellant would not have exercised Option B. Accordingly, there are various circumstances in which the options might not be exercised together. E F G

H

27. There was a dispute between the parties about whether the Appellant thought that there might be a tax benefit to Option B. If the Appellant were of that view, it strengthens the Respondent's argument that the two options should be considered together because they would need to be exercised together. Citibank's original proposal of 22 June 1995 expected that Option B would be exercised before the commencement date of the new legislation in which case any profit would be exempt. However, Citibank's later "deal structure" document faxed to Mr. Paterson on 27 June 1995 [J/10] states: ". . . it is conceivable that the premium paid on [Option B] may be added to the purchase price of the bonds when the option is exercised (since no relief has been obtained under the capital gains tax rules)." No mention of this possibility is made in Mr. Burke's I

A memorandum of 23 June [J/7], revised on 26 June [J/9] or the supplementary note of 26 June [J/11] by Mr. Gillon for the Appellant's Board meeting. All of these were made before the 27 June deal structure document and refer to a loss of £30 million entirely from Option A. We find therefore that it was not part of the Appellant's plan to obtain any tax advantage from Option B and it is therefore to be regarded as hedging the risk relating to Option A. Accordingly, it was not B part of the Appellant's plan that both options must be exercised at the same time. Indeed it may have been their original intention to exercise Option B before the legislation coming into force, which, with the benefit of hindsight, would have been the better course of action.

28. We find that the Collateral Agreement [J/20] is separate from the two C options. It consisted of a genuine loan or at least a genuine deposit. Its purpose was to provide Citibank with security and to remove the incentive for Citibank to exercise Option A early. There was no right to offset it against payments under the options.

D **Mark to market**

29. For the Appellant to succeed under the legislation which we consider below it has to show that the mark to market basis of accounting, that is that the options should be valued in the accounts on each accounting date and the profit determined by the difference, is applicable to the transactions; if the alternative E accruals basis of accounting applied there would be no loss accruing on 1 April 1996. Section 156 of the Finance Act 1994 provides:

"(1) Where, for the purposes of a qualifying company's accounts, profits and losses for an accounting period on a qualifying contract held by the company are computed on—

F (a) a mark to market basis of accounting which satisfies the requirements of this section, or

(b) an accruals basis of accounting which satisfies those requirements, profits and losses for the period on the contract shall be computed on that basis for the purposes of this Chapter.

. . .

G (3) A mark to market basis of accounting satisfies the requirements of this section as regards a qualifying contract if—

(a) computing the profits or losses on the contract on that basis is in accordance with normal accountancy practice;

H (b) all relevant payments under the contract are allocated to the accounting periods in which they become due and payable; and

(c) the method of valuation adopted is such as to secure the contract is brought into account at a fair value."

30. This requires determining whether computing the profits or losses on these particular options on a mark to market basis is in accordance with normal I accountancy practice. There is the obvious difficulty that the options were left out of the 1995 accounts of the Appellant in error. However, the fact that they

were valued for the purpose of including in the accounts suggests that this is what the Appellant intended to do. A

31. Paragraph 14 of FRS 5 [M/Accounting Texts, tab 3] (i.e. Financial Reporting Standard issued in April 1994) provides that the substance of transactions should be reported in the accounts. In the case of options, para 19 provides that "their commercial effect should be assessed in the context of all the aspects and implications of the transaction in order to determine what assets and liabilities exist." Paragraph 59 explains that normally an option should be treated as a separate asset from the underlying asset on which it is based. Paragraph 61 provides that: B C

> "in determining the substance of a transaction incorporating options, greater weight must be given to those aspects and implications more likely to have a commercial effect in practice. This will involve considering the extent to which there is a genuine commercial possibility that the options will be exercised or, alternatively that they will not be exercised." D

32. Taking these together, we find that normally a life assurance company would account for options by considering each to be a separate asset or liability. It would be normal accounting practice to mark to market such options (unless designed as a hedge). In relation to Options A and B in the light of our previous finding about the possibility of the price of the gilt falling below 90, we find that there was a genuine commercial possibility of Option B not being exercised. Such a view must be made at the time of grant of the options and the treatment does not vary because of later events. In particular, the agreement made on 28 March 1996 to net off the transactions if both options were exercised does not affect this point. E F

33. The policy of the Appellant was to compute the profit and loss of each of the options for the accounting period to 31 December 1995 separately on a mark to market basis. Because of an error, the valuations that had been made of the options were omitted from the balance sheet on that date. They were included in the returns to the Department of Trade and Industry, which resulted in the error being spotted. It was accordingly the view of the Appellant's management at the time of grant of the options that there was a commercial possibility that one of them might not be exercised. We find that the treatment that the Appellant intended to apply was in accordance with normal commercial accountancy that the options should be accounted for as separate assets on a mark to market basis. G H

34. Finally, in relation to the correct accounting treatment, we find that the £20 million under the collateral agreement could not be netted off against the options. This is because there was no right to insist on a net settlement of the amount payable under the options and the receivable under the Collateral Agreement. Following the agreement to set-off on 28 March 1996, it was proper to net them off. The mark to market basis still applied because that had to be determined at the time of grant of the options. But following the agreement to net off, it applied to the net amount. I

A **The approach to interpreting legislation in relation to a tax avoidance scheme**

35. We remind ourselves that judicial anti-avoidance doctrines are an approach to statutory construction. Following *MacNiven* v. *Westmoreland* [2001] STC 237, one must identify the concept to which the statute refers and determine whether this is a legal one or a commercial one. As Lord Hoffmann B said at p 257a "The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether it applies or not." The statute which we consider below uses commercial concepts like normal accounting practice and couples these with extremely detailed legislation involving formulae for computing profit or loss. Such detailed statutory material C does not generally leave room for a commercial interpretation; the concepts are in the main legal concepts.

Application of the legislation

D 36. Accordingly, we turn to attempting to apply this complex statutory code to the transactions.

37. Section 154 of the Finance Act 1994 provides:

> "(1) Subject to subsections (2) and (3) below, any company is a qualifying company for the purposes of this Chapter."

E

Subsections (2) and (3) are not relevant. The Appellant is accordingly a qualifying company.

38. Section 150A provides:

F
> "(1) A contract is a debt contract for the purposes of this Chapter if, not being an interest rate contract or option or a currency contract or option—
>
> (a) it is a contract under which, whether unconditionally or subject to conditions being fulfilled, a qualifying company has any entitlement, or is subject to any duty, to become a party to a loan relationship; and
>
> G
>
> (b) the only transfers of money or money's worth for which the contract provides (apart from those that will be made under the loan relationship) are payments falling within subsection (5) below and payments falling within section 151 below.
>
> . . .
>
> H (5) The payments falling within this subsection are—
>
> (a) a payment of an amount representing the price for becoming a party to the relationship;
>
> (b) a payment of an amount determined by reference to the value at any time of the money debt by reference to which the relationship subsists;
>
> I
>
> . . .

(11) For the purposes of this section and, so far as it relates to a debt contract or option, of section 151 below the transfer of money's worth having a value of any amount shall be treated as the payment of that amount." A

Section 151(1) provides: B

"(1) An interest rate contract or option, [a currency contract or option or a debt contract or option] may include provision under which the qualifying company—

. . .

(b) becomes subject to a duty to make a payment in consideration of another person's entering into the contract or option." C

39. Subsection (1)(a) of s 151 is satisfied as the Appellant and Citibank have an entitlement to become party to a loan relationship, namely the gilt. Subsection (1)(b) is satisfied because the only payments are within subs (5) of s 150A, being the price paid for the options, the price paid for the exercise of the options, and, reading subs (5)(b) together with subs (11), the transfer of the gilts pursuant to the options. The fee of £60,000 built into the option price is part of the price for becoming party to the relationship within subs (5)(a). There is no entitlement to rewrite the contract on the basis that Citibank treated it separately for their internal accounting. The success fee is within s 151(1) as a payment that the Appellant is under a duty to make in consideration of Citibank's entering into the options. D E

40. The Collateral Agreement is clearly linked to the options but it is a separate agreement making a loan or deposit that is not part of the options. Mr. Moynihan argued that in any practical sense the collateral amount is part of the consideration for Option A, and legally that is so, also because it is payable when Option A is exercised. We do not agree. It is a loan or deposit which is repaid when the options are exercised. The only consideration is the interest foregone which is neither "the payment of an 'amount'" within subs (5) of s 150A nor "the transfer of money's worth" within subs (11) of that section. If we are wrong about this, it can be ignored under s 152 as being small. Section 152 provides:— F G

"(1) Where—

(a) but for the inclusion in a contract or option of provisions for one or more transfers of money or money's worth, the contract or option would be a qualifying contract; and H

(b) as regards the qualifying company and the relevant time, the present value of the transfer, or the aggregate of the present values of the transfers, is small when compared with the aggregate of the present values of all relevant payments,

the contract or option shall be treated for the purposes of section 149 or, as the case may be, section 150 [or 150A] above as if those provisions were not included in it. I

(2) For the purposes of subsection (1) above—

(a) any present value of a relevant payment which is a negative value shall be treated as if it were the equivalent positive value; and

A (b) any relevant payment the amount of which represents the difference between two other amounts shall be treated as if it were a payment of an amount equal to the aggregate of those amounts.

(3) In this section—

'relevant payments' means—

B (a) in relation to a contract, qualifying payments under the contract;

. . ."

The computation of what is small depends on comparing the interest foregone on £20 million for 9 months, say £1 million, with the total of the positive C and negative qualifying payments, that is (ignoring the 9 month delay and taking the value of the gilts as it turned out to be on the day of exercise of 104) of 90 + 70 + 104 + 104 = 368 million. The amount is clearly small.

If we are wrong about either the £60,000 fee built into the option price or the success fee of up to £240,000 these are separately or together small in relation to this total.

D

41. Accordingly the options are debt contracts within s 150A. We turn to whether they are qualifying contracts. Section 147A provides:

"(1) For the purposes of this Chapter a debt contract or option is a qualifying contract as regards a qualifying company if the company becomes entitled to rights, or subject to duties, under the contract or option E at any time on or after 1st April 1996.

(2) For the purposes of this Chapter a qualifying company which is entitled to rights, or subject to duties, under a debt contract or option both immediately before and on 1st April 1996 shall be deemed to have become entitled or subject to those rights or duties on that date.

F (3) This section has effect subject to paragraph 25 of Schedule 15 to the Finance Act 1996 (transitional provisions)."

This must be read with s 177(2):

"(2) For the purposes of this Chapter—

G (a) a company becomes entitled to rights or subject to duties under an interest rate contract or option, [a currency contract or option or a debt contract or option], when it becomes party to the contract or option; and

(b) a company holds such a contract or option at a particular time if it is then entitled to rights or subject to duties under it;

H and it is immaterial for the purposes of paragraph (b) above when the rights or duties fall to be exercised or performed."

It is common ground that the transitional provisions referred to in s 147A(3) do not apply because we are dealing with a mutual insurance company and gilts which are not within the capital gains regime. Mr. Aaronson also raised an I argument that the transitional provisions only apply to assets and not liabilities, with which Mr. Moynihan did not agree. It is not necessary for us to decide the

point. Mr. Moynihan argues that because of the agreement to net off made on 28 March 1996 there were no subsisting rights and duties under the options. We do not agree. The agreement to net off said merely that if both parties exercised their options, then neither stock nor money would be exchanged; and if the Appellant did exercise its option then Citibank should be taken to have exercised its option. Both options continued in place and although, by 28 March 1996, both parties expected to exercise their options, their rights and duties under the two options continued to subsist. Since the Appellant is entitled to rights and subject to duties under the options before and on 1 April 1996 for the purpose of s 147A(2), the Appellant is deemed to have become entitled to rights or subject to duties on 1 April 1996. By virtue of s 147A(1), the options are accordingly qualifying contracts.

42. Section 155(7) provides:

"(7) Subject to subsection (8) below, where a qualifying contract—

(a) becomes held by a qualifying company at any time in an accounting period, or

(b) ceases to be so held at any such time,

it shall be assumed for the purposes of subsection (4) above that its value is nil immediately after it becomes so held or, as the case may be, immediately before it ceases to be so held."

Subsection (8) is not relevant. Section 147A(2) deems the Appellant to have become entitled to rights under the contracts on 1 April 1996. Mr. Moynihan argued that it did not follow that the contracts became held on 1 April 1996 so as to make s 155(7) apply because that did not apply to deemed acquisitions. He argued that deeming should not be allowed to produce an unjust or absurd result following cases such as *Marshall* v. *Kerr* (1994) 67 TC 56 at p 79A-C, *per* Peter Gibson J. and p 92H *per* Lord Browne-Wilkinson. It seems to us that since by s 177(2)(b) a company holds a contract at a particular time if it is then entitled to rights or subject to duties under it, it follows that where a company is deemed to have become entitled to rights under a contract on 1 April 1996, the contract is deemed to have become held on that date so as to make s 155(7) applicable. The result is that it is to be assumed that the value of the contract is nil immediately after it is deemed to have become held on 1 April 1996. At first sight the provision is odd but the reason for it seems to be that, ignoring the transitional date, payments for entering into the contract are taken into account and so it is not appropriate for the value of the contract to be taken into account at the same time. It is not a case of deeming producing an unjust or absurd result but of detailed statutory language avoiding double counting.

43. We have at last reached the point. Section 155(4) contains the calculation to be made

"Where, as regards a qualifying contract held by a qualifying company and an accounting period, amount A exceeds amount B, a profit on the contract of an amount equal to the excess accrues to the company for the period.

. . .

A (4) Where as regards a qualifying contract a qualifying company's profit or loss for an accounting period falls to be computed on a mark to market basis incorporating a particular method of valuation—

(a) amount A is the aggregate of—

B (i) the amount or aggregate amount of the qualifying payment or payments becoming due and payable to the company in the period, and

(ii) any increase for the period, or the part of the period for which the contract is held by the company, in the value of the contract as determined by that method, and

(b) amount B is the aggregate of—

C (i) the amount or aggregate amount of the qualifying payment or payments becoming due and payable by the company in the period, and

(ii) any reduction for the period, or the part of the period for which the contract is held by the company, in the value of the contract as so determined."

D

We have already found that the correct basis of accounting was to mark to market so that subs (4) applies. For Option A and assuming that the price of the gilt on the date of exercise is 104 (as put forward by the Appellant; Mr. Moynihan worked on the basis that the value was 101, but whatever the price the amount E will cancel out) and ignoring any increase in value during the day, amount A is £70 million and amount B is £104 million, resulting in a loss of £34 million. For Option B amount A is £90 million and amount B is £104 million, resulting in a profit of £14 million. The net effect is a loss of £20 million (using the round figures we have used throughout).

F 44. At this point we stand back and, like Mr. Moynihan, ask whether, having accepted that a mark to market basis of accounting is appropriate on the basis of normal accountancy practice, a loss of £30 million and a gain of £10 million can occur in the course of 1 April 1996 when plainly the value of the options did not change and such a loss and gain is not in accordance with normal accountancy practice. In particular, it cannot have been Parliament's intention to tax the gain on Option B which could occur in circumstances far removed from G any tax avoidance scheme. We agree that the result is unexpected but it follows from the application of detailed statutory provisions that do not leave room for application of a different result. The legislation, while stating in s 156(1), that profits and losses are computed for tax purposes on the mark to market basis, where this is applicable, requires one to apply the formula set out in s 155 regardless of whether the result is in accordance with normal accountancy H practice. The mark to market basis of accounting in accordance with normal accountancy practice precedes the application of the formula, and is not the result of applying the formula. What is wrong here is that the transitional provisions do not apply in the circumstances of this case, presumably because the draftsman did not foresee those circumstances (hence the own goal analogy), which is not a reason for not giving the statutory provisions anything other than I their normal meaning, particularly so in the case of detailed legislation of this type.

45. Accordingly, the appeal is allowed in principle. We have used round figures in this decision and we expect the parties will be able to agree the precise figures. We authorise them to apply for further Directions etc. if they cannot agree. A

Mr. J Gordon Reid Q.C. and Dr. John F Avery Jones—Special Commissioners B

The Crown's appeal to the First Division of the Inner House was heard before the Lord President, Lady Cosgrove and Lord Eassie on 13, 15, 16 and 20 May when judgment was reserved. On 3 July and 26 September 2003, judgment was given against the Crown, with expenses. C

Colin Tyre Q.C. for the Company.

G J B Moynihan Q.C., and *Jane Paterson* for the Crown. D

The cases referred to in the opinion are as follows:—*Barclays Mercantile Business Finance Ltd.* v. *Mawson (HMIT)* [2002] EWCA Civ 1853; TC Leaflet 3673; [2003] STC 66; *Commissioner of Inland Revenue* v. *Luke* [1963] AC 557; (1963) 40 TC 630; [1963] 1 All ER 655; *Chevron UK Ltd.* v. *Commissioners of Inland Revenue* (1995) 67 TC 414; [1995] STC 712; *Craven (HMIT)* v. *White* [1989] AC 398; (1988) 62 TC 1; [1988] 3 WLR 423; [1988] 3 All ER 495; [1988] STC 476; *Edwards (HMIT)* v. *Bairstow & Harrison* [1956] AC 14; (1955) 36 TC 207; [1955] 3 All ER 48; *Furniss (HMIT)* v. *Dawson* [1984] AC 474; (1984) 55 TC 324; [1984] 1 All ER 530; [1984] STC 153; *Griffin (HMIT)* v. *Citibank Investments Ltd.* [2000] STC 1010; *HSBC Life (UK) Ltd.* v. *Stubbs (HMIT)* [2002] STC (SCD) 9; *Jenks* v. *Dickinson (HMIT)* (1997) 69 TC 458; [1997] STC 853; *MacNiven (HMIT)* v. *Westmoreland Investments Ltd.* [2001] UKHL 6; [2003] 1 AC 311; (2001) 73 TC 1; [2001] 2 WLR 377; [2001] 1 All ER 865; [2001] STC 237; *WT Ramsay Ltd.* v. *Commissioners of Inland Revenue* [1982] AC 300; (1981) 54 TC 101; [1981] 2 WLR 449; [1981] 1 All ER 865; [1981] STC 174. E F

The cases cited in the arguments were as follows:—*Marshall (HMIT)* v. *Kerr* [1995] 1 AC 148; (1994) 67 TC 56; *R (Alconbury Developments Ltd. and others)* v. *Secretary of State for the Environment, Transport and the Regions* [2001] 2 WLR 1389; *Save Britain's Heritage* v. *Number 1 Poultry Lane Ltd. and others* [1991] 1 WLR 153; *Wordie Property Co. Ltd.* v. *Secretary of State for Scotland* 1984 SLT 345. G H

The Lord President (Lord Cullen) [for the Court—the Lord President, Lady Cosgrove and Lord Eassie]:—
3 July 2003 I

1. This appeal is against a decision of the Special Commissioners in which they allowed, in principle, an appeal by the Respondents against an assessment for the period ended 31 December 1996. The only matter with which the Special Commissioners were concerned was whether a sum of approximately £20 million

A was allowable as a loss for the purposes of tax. The Appellants maintain that in a number of respects the Special Commissioners erred in law and accordingly that their decision should be reversed.

2. The circumstances out of which the appeal arises are briefly as follows. In May 1995 the Inland Revenue published a consultative document which B proposed a major simplification of the current tax rules applicable to gilts and bonds, including derivatives such as options, by treating profits as of an income nature with losses being relievable against income. The rules for corporate holders were to parallel the rules for new financial instruments which had been made by the Finance Act 1994 ("the 1994 Act").

C 3. On or about 20 June 1995 Citibank NA ("Citibank"), which is an American bank with a branch registered in the UK, proposed to the Respondents, with whom they had an established relationship, a scheme which had as its object the creation of expenses within the new proposed tax regime. Following discussion between the Respondents and Citibank, four documents comprising the scheme were executed on or about 30 June 1995. As at that date D the details of the proposed legislation were not yet known. The four documents are briefly described in what follows.

4. First, the Respondents granted a call option to Citibank (referred to as Transaction A), in respect of £100 million of nominal amount of 8 per cent. UK gilts due 7 December 2000 at an option price of 70 per cent. of the par value of E the bonds plus accrued interest. The option was exercisable by Citibank at any time between 30 August 1995 and 1 April 1996. The premium for the option was £29,750,000 payable to the Respondents on 5 July 1995. Provision was made for notice of the exercise of the option to be given. In that event the bonds were to be delivered in exchange for payment.

F 5. Secondly, Citibank granted a call option to the Respondents (referred to as Transaction B) in respect of £100 million of nominal amount of 8 per cent. UK gilts due 7 December 2000 at an option price of 90 per cent. of the par value of the bonds plus accrued interest. The option was exercisable by the Respondents at any time between 30 August 1995 and 1 April 1996. The premium for the option was £9,810,000 payable to Citibank on 5 July 1995. Provision was made G for notice of the exercise of the option to be given. In that event the bonds were to be delivered in exchange for payment.

6. Thirdly, the Respondents entered into a Collateral Agreement in respect of Transaction A, under which they were required to pay Citibank on 5 July 1995 the Collateral Amount, which was defined as:

H "an amount of pounds sterling equal to the bond entitlement of Transaction A multiplied by the difference between the option strike price of Transaction A and the option strike price of Transaction B."

This amounted, in broad terms, to £20 million. Under the agreement it fell I to be repaid by Citibank, without interest, on the earlier of the day on which the option under Transaction A was exercised and 1 April 1996.

7. Fourthly, the parties also entered into a further agreement which entitled Citibank to a structuring fee calculated by reference to the Respondents' long-term business funds, less an initial fee of £60,000 and subject to a maximum of £240,000. This agreement provided for payment on 1 September 1996. It may be noted that the total of £60,000 and £240,000, namely £300,000, represented 10 per cent. of 15 per cent. (the assumed tax rate) on £20 million.

8. On 5 July 1995 the sum of £60,000 was paid by the Respondents to Citibank. This was the difference between the sums payable by the Respondents to Citibank (£9,810,000 and £20 million) and the sum payable by Citibank (£29,790,000).

9. On or about 12 July 1995 the Inland Revenue announced that the commencement of the new rules for the taxation of gilts and capital bonds would be deferred until 1 April 1996.

10. By letter to Citibank dated 20 March 1996 the Respondents intimated that, in the absence of further instructions, if Citibank exercised its option under Transaction A on 1 April 1996, the letter was to be treated as constituting notice by the Respondents of the exercise of their option under Transaction B on the same date. By letter in reply, on or about 28 March 1996, Citibank confirmed that if both options were to be exercised on 1 April 1996, stock deliveries and all sums due (including the £20 million Collateral Amount) under Transaction A would be netted off for settlement purposes, with the result that neither stock nor money would be exchanged. The letter further provided that, in the absence of further instructions, if the Respondents exercised their option under Transaction B on 1 April 1996, the letter was to constitute notice by Citibank of the exercise of their option under Transaction A on the same date. The terms of that letter were agreed by the Respondents on or about 28 March 1996. Neither party provided further instructions.

11. On 1 April 1996 the options under both transactions were exercised. No bonds were delivered or payment made by either party to the other.

12. It is not in dispute that the scheme which was devised by Citibank was based on the expectation that the premium which was paid for the option under Transaction A before the legislation came into force would fall out of account for taxation purposes. It was not taxable under the pre-existing law, in respect that options over gilts had not previously been liable to tax on capital gains. Further, it was intended that the Respondents would obtain the benefit of a loss for taxation purposes arising from the exercise by Citibank of the option under Transaction A when the new legislation was in force. It was not part of the scheme that the Respondents would obtain any tax advantage from the exercise of their option under Transaction B. The Respondents and Citibank proceeded on the basis that Transaction B hedged the risk to the Respondents arising from the exercise by Citibank of their option under Transaction A.

13. We turn next to the legislation with which the present appeal is concerned.

A 14. Chapter II of the 1994 Act made provision for the tax treatment of profits and losses in respect of interest rate and currency contracts. Section 155 states in its first two subsections:

> "(1) Where, as regards a qualifying contract held by a qualifying company and an accounting period, amount A exceeds amount B, a profit on the contract of an amount equal to the excess accrues to the company for B the period.
>
> (2) Where, as regards a qualifying contract held by a qualifying company and an accounting period, amount B exceeds amount A, a loss on the contract of an amount equal to the excess accrues to the company for the period."

C Section 154(1) provides that, subject to certain exceptions, with which we are not concerned, any company is a "qualifying company" for the purposes of Chapter II.

15. Section 155 goes on to make provision as to how amounts A and B are to be arrived at, depending on whether profit or loss falls to be computed on a D mark to market basis (subs (4)) or on a particular accruals basis (subs (5)). In the present case we are concerned only with the application of the mark to market basis, which involves in general the revaluation of the contract at the beginning and at the end of the accounting period.

16. Subsection (4) provides:

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> "Where as regards a qualifying contract a qualifying company's profit or loss for an accounting period falls to be computed on a mark to market basis incorporating a particular method of valuation—
>
> (a) amount A is the aggregate of—
>
> (i) the amount or aggregate amount of the qualifying F payment or payments becoming due and payable to the company in the period, and
>
> (ii) any increase for the period, or the part of the period for which the contract is held by the company, in the value of the contract as determined by that method, and
>
> (b) amount B is the aggregate of—
>
> G (i) the amount or aggregate amount of the qualifying payment or payments becoming due and payable by the company in the period, and
>
> (ii) any reduction for the period, or the part of the period for which the contract is held by the company, in the value of the H contract as so determined."

17. Section 156(1) provides that profits and losses are to be computed on a mark to market basis where they are computed on that basis for the purposes of the accounts of the qualifying company if that basis satisfies the requirements of subs (3). These requirements are:

I
> "(a) computing the profits or losses on the contract on that basis is in accordance with normal accountancy practice;

(b) all relevant payments under the contract are allocated to the accounting periods in which they become due and payable; and

(c) the method of valuation adopted is such as to secure the contract is brought into account at a fair value."

18. The original scope of the expression "qualifying contract" was extended by the addition of s 147A to the 1994 Act by the Finance Act 1996 ("the 1996 Act"). The first two subsections of that section provide:

"(1) For the purposes of this Chapter a debt contract or option is a qualifying contract as regards a qualifying company if the company becomes entitled to rights, or subject to duties, under the contract or option at any time on or after 1st April 1996.

(2) For the purposes of this Chapter a qualifying company which is entitled to rights, or subject to duties, under a debt contract or option both immediately before and on 1st April 1996 shall be deemed to have become entitled or subject to those rights or duties on that date".

Subsection (3) states that the section has effect subject to the transitional provisions contained in para 25 of Sch 15 to the 1996 Act.

19. The 1996 Act also added to the 1994 Act s 150A which defined the scope of "a debt contract or option". It is not in dispute that Transaction A and Transaction B fell within the scope of "a debt contract or option". It may also be noted that a "qualifying payment" for the purposes of s 155(4) was extended to include, in terms of s 150A(5):

"(a) a payment of an amount representing the price for becoming a party to the [loan] relationship;

(b) a payment of an amount determined by reference to the value at any time of the money debt by reference to which the relationship subsists;

(c) a settlement payment of an amount determined by reference to the difference at specified times between—

(i) the price for becoming a party to the relationship; and

(ii) the value of the money debt by reference to which the relationship subsists, or (if the relationship were in existence) would subsist."

20. Lastly, we return to s 155 in which it is provided by subs (7), subject to an exception with which we are not concerned, that

"where a qualifying contract—

(a) becomes held by a qualifying company at any time in an accounting period, or . . .

(c) ceases to be so held at any such time,

it shall be assumed for the purposes of subsection (4) above that its value is nil immediately after it becomes so held or, as the case may be, immediately before it ceases to be so held."

It appears that the general purpose of this provision is to avoid the duplication between payments and changes in value in the accounting which is

A required by subs (4). In this connection, as we will explain later in this Opinion, reference was made to s 177(2) of the 1994 Act, as amended by the 1996 Act, which provides:

> "For the purposes of this Chapter—
>
> (a) a company becomes entitled to rights or subject to duties under an interest rate contract or option, a currency contract or option or a debt
B contract or option when it becomes party to the contract or option; and
>
> (b) a company holds such a contract or option at a particular time if it is then entitled to rights or subject to duties under it; and it is immaterial for the purposes of paragraph (b) above when the rights or duties fall to be exercised or performed."

C 21. The Special Commissioners held that each of Transaction A and Transaction B was a "qualifying contract" for the purposes of Part II of the 1994 Act as amended; and that profits and losses in respect of each transaction fell to be computed on a mark to market basis in accordance with s 155(4). They further held that, for the purposes of that computation, in the case of Transaction A, amount A was £70 million and amount B was £104 million (under s 155(4), paras
D (a)(i) and (b)(i) respectively). In the case of Transaction B, amount A was £104 million and amount B £90 million (under paras (a)(i) and (b)(i) respectively). This yielded a loss in the case of Transaction A of £34 million and a profit in the case of Transaction B of £14 million, and thus an overall loss of £20 million. It may be noted that it is evident that the Special Commissioners entered no amount against paras (a)(ii) or (b)(ii) in respect of either transaction, upon the view that
E the combined effect of ss 147A(2) and 155(7) was that it was to be assumed that the value of each of these contracts was nil immediately after it was deemed to have become held on 1 April 1996 as well as immediately before it ceased to be held on that same date.

22. The issues which were debated in this appeal, and in the order in which
F they were presented, were as follows:

> "(1) was it appropriate to compute profit and loss on each of Transaction A and Transaction B on a mark to market basis?
>
> (2) was each of Transaction A and Transaction B a qualifying contract?
>
> (3) was it appropriate when applying a mark to market basis to attach
G a nil value to each of these transactions on the morning of 1 April 1996? and
>
> (4) was it appropriate to exclude from the computation the Collateral Amount of £20 million?"

**(1) Was it appropriate to compute profit and loss on each of Transaction A
H and Transaction B on a mark to market basis?**

23. For the Appellants Mr. Moynihan invoked the line of authority beginning with the decision of the House of Lords in *W T Ramsay Ltd.* v. *Commissioners of Inland Revenue* [1982] AC 300; (1981) 54 TC 101; [1981] STC 174 and considered most recently in *MacNiven (HMIT)* v. *Westmoreland*
I *Investments Ltd.* [2003] AC 311; (2001) 73 TC 1; [2001] STC 237. In *MacNiven* it was held that the first step in the process of ascertaining the meaning of a

statutory provision was the identification of the concept to which the statute referred. If the statutory language was construed as referring to a commercial concept, and steps which had no commercial purpose had been artificially inserted for tax purposes into a composite transaction they would be disregarded for the purposes of applying the relevant concept. On the other hand, as Lord Hoffmann observed at para 62:

> "The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether it applies or not."

Mr. Moynihan criticised the Special Commissioners for taking an unduly restrictive view. It was wrong for them to conclude, as they indicated in para 35([1]) of their decision, that a commercial approach was inappropriate simply because the legislation was complex.

24. Mr. Moynihan referred to the comments which the members of the House had made in *MacNiven* on the observation of Lord Brightman in *Furniss* v. *Dawson* (1984) 55 TC 324; [1984] AC 474 at p 527 as to the "limitations of the *Ramsay* principle". Lord Brightman said, in short, that there must be a pre-ordained series of transactions, or a single composite transaction, containing steps inserted which had no business purpose apart from the avoidance of a liability to tax. Where those two ingredients existed, the inserted steps were to be disregarded for fiscal purposes. At [2003] AC 311; (2001) 73 TC 1, para 49 Lord Hoffmann emphasised that this formulation was not a principle of construction:

> "It is a statement of the consequences of giving a commercial construction to a fiscal concept. Before one can apply Lord Brightman's words, it is first necessary to construe the statutory language and decide that it refers to a concept which Parliament intended to be given a commercial meaning capable of transcending the juristic individuality of its component parts."

Further, Lord Nicholls of Birkenhead remarked, at para 7, that observations such as those of Lord Brightman should be read in the context of the particular statutory provisions and sets of facts under consideration:

> "In particular, they cannot be understood as laying down factual pre-requisites which must exist before the court may apply the purposive, *Ramsay* approach to the interpretation of a taxing statute."

He went on to state in para 8 that:

> ". . . the *Ramsay* approach is no more than a useful aid. This is not an area for absolutes. The paramount question always is one of interpretation of the particular statutory provision and its application to the facts of the case."

25. Accordingly, Mr. Moynihan submitted, the relevant question was whether the particular provision under interpretation employed a commercial concept in which case it might be possible to apply a commercial approach to it.

([1]) Page 555 *ante*

A In the present case s 156(3) required the application of a commercial concept by stating that the computation should be "in accordance with normal accounting practice". In these circumstances, as Lord Hoffmann stated in *MacNiven* at para 34, "It is thus the statute itself which applies the tests of ordinary business". It was therefore, he submitted, permissible to use a commercial approach. That meant that where a series of legally separate, genuine transactions were B nonetheless designed, intended and in fact operated as one composite transaction, one could assess the fiscal consequences by reference to the end result. This did not involve "laying down factual pre-requisites". It did not permit the retrospective reconstruction as a composite of what had been prospectively uncertain in the sense that the end result was not known in advance and only came about as a result of the juxtaposition of later events (cf. *Craven* v. *White* [1989] AC 398; (1988) 62 TC 1). On the other hand one should not C deconstruct what prospectively was designed and intended as a composite and was in fact executed as a composite. What was designed, intended and operated as a composite was not deprived of that status merely because there might have been some intermediate variation in the plan. That was particularly so if the parties built into the plan checks and balances to guard against that variation, even more so if those checks and balances successfully prevented the variation D from arising. Mr. Moynihan criticised the Special Commissioners for having relied on the approach which had been taken by Patten J. in *Griffin (HMIT)* v. *Citibank Investments Ltd.* [2000] STC 1010, at para 38, where he applied the test of whether there was no practical likelihood that the pre-planned events would not take place in the order ordained. That test was derived from the passage in the speech of Lord Oliver of Aylmerton in *Craven* v. *White* [1989] AC 398 at p E 514, and in turn from the speech of Lord Brightman in *Furniss* v. *Dawson.* That did not square, he argued, with the application of "normal accountancy practice" in accordance with s 156(3).

26. Mr. Moynihan submitted that the Special Commissioners had erred in their approach to commerciality and the prospects of the options being exercised F separately. The Special Commissioners had found that the option contracts created a genuine economic risk for Citibank (para 5/12), and that when Transactions A and B were entered into along with the Collateral Agreement

> ". . . there was a genuine commercial possibility of movement of interest rates and gilt prices such that it would be in Citibank's commercial interests to either refrain from exercising Option A or exercising or G attempting to exercising (*sic*) it on a date different from the exercise by the [Respondents] of Option B. There was a genuine commercial possibility and a real practical likelihood that the two options would be dealt with separately. Likewise, there was a genuine commercial possibility and a real practical likelihood that Option B would not be exercised by the [Respondents]". (Para 5/18 cf. para 24).

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In para 25 they stated with reference to the options:

> "They were genuine transactions under which the parties could make a profit or loss even though the expectation was that they would not."

I Mr. Moynihan submitted, however, that the Special Commissioners had failed to consider the substance of the scheme as opposed to its form. They had

applied too much weight to the options and not paid attention to the other parts of the scheme which were designed to achieve a nil result. A

27. Mr. Moynihan drew attention in particular to two respects in which the scheme had checks and balances which were designed to avoid a profitable outcome. There would not have been these handicaps unless the parties had been engaged in a tax avoidance scheme rather than a commercial transaction. The Special Commissioners had failed to address these matters. The first was the reduction of the strike price of Transaction B from 95 to 90 during the course of negotiations (para 6). This increased the prospect of the option under Transaction B being exercised. It was, of course, obvious that with a strike price of 70 Citibank were even more likely to exercise the option under Transaction A. B C

28. The second was the provision of an interest-free loan or deposit of £20 million. It made sense only as part of a tax avoidance scheme. It meant that if Citibank exercised the option under Transaction A they were penalised by having to repay that sum immediately. In para 28([1]) the Special Commissioners had made contradictory findings. They had said, on the one hand, that the Collateral Agreement was separate from the two options and, on the other hand, that its purpose was "to provide Citibank with security and to remove the incentive for Citibank to exercise option A early". It was significant, he said, that the Special Commissioners' endorsement of the commerciality of the arrangements was confined to the two options. The question was not whether this arrangement was "genuine", as the Special Commissioners had stated in para 28, but whether it made any commercial sense. The conclusion of the Special Commissioners was also in conflict with the documents which demonstrated that the terms of the Collateral Agreement reflected the premiums for the two options. D E

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29. Mr. Moynihan also argued, as he had done before the Special Commissioners, that no one would have carried out these transactions for such a small possibility of profit. In para 25 the Commissioners stated that the Respondents had admitted that, adding:

> "they did it for tax reasons, not in any expectation of making a profit from the price of gilt falling below 90, but the point is that they did something that had a sufficient degree of uncertainty attached to it that we cannot ignore what they did." G

Mr. Moynihan submitted that it was entirely incorrect to say that Citibank were holding out a profit in return for the fee which they received. The fee was simply a premium for the scheme, including any hedging cost (paras 4, 6 and 24), and it made sense only if it was so considered. It bore no relationship to the possible measure of profit. It was not reasonable for the Special Commissioners to regard it as a fee for the options. It was a part of a wider whole. The Special Commissioners had wrongly attributed to the transactions the appearance of a genuine speculative venture which could lead to profit or loss. It was wrong to categorise the possibility of profit or loss as commercial, since it gave the scheme no more than the semblance of commerciality. Mr. Moynihan also maintained that it was inaccurate for the Special Commissioners to state, as they did in para H I

(1) Page 553 *ante*.

A 5/18, that the premiums were negotiated at market rates, since the fee of £60,000 had been added to the premium for Transaction B.

30. As regards the mark to market basis of accounting, Mr. Moynihan submitted that the Special Commissioners had failed to apply the correct test in relation to the existence of a composite transaction for the purposes of B accountancy practice. He referred to the guidance provided by the Financial Reporting Standard issued in April 1994 (FRS5). A number of passages in FRS5 showed that, according to normal accounting practice, regard should be had to the substance of a transaction, including the existence of a scheme which was designed to achieve an overall effect; the implications of the transaction should be examined, with greater weight attached to those matters which were more C likely to have commercial effect in practice; in determining the substance, the logic of the transaction should be considered. If it lacked logic this might be due to some element which had been incorrectly assessed; and particular care should be taken in the assessment of options which were written in terms which made it highly likely that they would be exercised. While the Special Commissioners had referred to FRS5, they failed to give effect to its guidance and in particular did D not ask themselves what was more likely to happen, although they came close (in para 25([1])) to acknowledging the practical likelihood that, subject to the contingency that the legislation would be as had been anticipated, the transactions would be carried out in the way which had been anticipated from the outset. Although it was said that the Respondents might have exercised the option in Transaction B on 27 or 28 March 1996, with the result that the profit which they would have taken on the exercise of that option would not have been E caught by the new legislation, the fact was that they did not do so. On 1 April 1996 the two options were exercised and the Collateral Amount settled in a single operation. There was no question of an *ex post facto* juxtaposition of events. What occurred was intended, and was always likely, to happen. To rely on the possibility of the separate exercise of Transaction B was to give way to a reconstruction of events. Accordingly, even on the basis of the test of "no F practical likelihood", that test was met. It made no sense to attribute separate values to components of the scheme which were intended to cancel out each other.

31. Mr. Moynihan also criticised the decision of the Special Commissioners in two other distinct respects. First, they failed to explain why, despite their G remark in para 32 that "it would be normal accounting practice to mark to market such options (unless designed as a hedge)", they thought that this basis was appropriate, standing their finding in paras 3 and 27 that the option under Transaction B should be regarded as hedging the risk relating to the other option. Secondly, assuming that the correct date as at which the transaction should be considered was 30 June 1995 (which was disputed), they had wrongly relied on H the effect of the announcement by the Inland Revenue on or about 12 July 1995. According to para 5/14 this "introduced a potential investment risk for Citibank", the risk being the possibility that gilts would fall below 90 per cent. of their nominal value, that being the strike price of Transaction B. The measure of that risk could be seen from the figures in para 23. Yet the Special Commissioners in para 32 considered that the possibility of the option under

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([1]) Page 552 *ante*.

Transaction B not being exercised should be viewed as at the time of the grant of the options. A

32. For the Respondents Mr. Tyre submitted that the Appellants' approach was not in accordance with the law as it had been developed in the House of Lords. He drew attention to the observations of Lord Oliver of Aylmerton in *Craven* v. *White* [1989] AC 398, at pp 503–504. Lord Oliver pointed out at [1989] AC 398, at p 503; (1988) 62 TC 1, at p 193 that the essence of the decision in *Ramsay* B

> ". . . lay not in the fact that the object of the exercise was to save tax but in the approach of the court as a matter of construction to a devised combination of events designed to produce an actual result quite different from that which, for fiscal purposes, it was intended to display." C

The argument for the Appellants in the present case resembled the submission on behalf of the Revenue which had been rejected in *MacNiven* (see Lord Hoffmann at paras 27-29), and the approach taken by Lord Templeman in his dissenting speech in *Craven* v. *White* [1989] AC 398, at p 492; (1988) 62 TC 1, at p 183 where he said: D

> "First, the taxpayer must decide to carry out, if he can, a scheme to avoid an assessment of tax on an intended taxable transaction by combining with a prior tax avoidance transaction. Secondly, the tax avoidance transaction must have no business purpose apart from the avoidance of tax on the intended taxable transaction. Thirdly, after the tax avoidance transaction has taken place, the taxpayer must retain power to carry out his part of the intended taxable transaction. Fourthly, the intended taxable transaction must in fact take place." E

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Accordingly expressions such as "a commercial approach", "commercial validity", and "failure to address the scheme as a whole" indicated an attempt to apply the wrong test (cf. Carnwath L.J. in *Barclays Mercantile Business Finance Ltd.* v. *Mawson (HMIT)* [2002] EWCA Civ 1853; [2003] STC 66 ; TC Leaflet 3673, at paras 60 *et seq*). G

33. In the light of the speech of Lord Hoffmann in *MacNiven* Mr. Tyre submitted that the Appellants required to demonstrate two matters. First, it was necessary for them to identify a concept in the tax legislation which in its context fell to be given a commercial and not a legal (i.e. statutorily defined) meaning (Lord Hoffmann at para 58). If they could not do so, there was no room for the *Ramsay* approach, because in that event a business purpose was not a part of the relevant concept. Secondly, if, and only if, the Appellants could identify such a concept, they must also be able to establish that there was a single composite transaction into which steps had been inserted artificially for tax purposes. Those steps might then be disregarded (Lord Hoffmann at paras 48-49). For this purpose the question was not whether those steps would be separately marked to market. In determining whether there was a single composite transaction the statement of the law by Lord Oliver of Aylmerton in *Craven* v. *White* [1989] AC 398, at p 514, which had been consistently applied, still held good. Thus the critical question was whether, at the time when the transactions were entered into, there was H I

A "... no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life."

The Special Commissioners had been correct in applying this test, which was the basis for the decision in *Griffin (HMIT)* v. *Citibank Investments Ltd.* The B observations of Lord Brightman in *Furniss* v. *Dawson* remained authoritative in regard to the question whether there was a composite transaction. It was plain that the question of practical likelihood required to be considered as at the time when the transactions were entered into and not, as was suggested by the Appellants at one stage of their argument, by reference to the end result.

C 34. As regards the first test which was propounded by him, Mr. Tyre submitted that s 155(2) was the critical provision. The word "loss" in the present context was a statutory construct, being the difference between amount A and amount B, if A was less than B. It followed that "loss" in the present context was a legal concept, being one which had a specific statutory meaning. Accordingly there was no justification for treating the amount which resulted from the D difference between amount A and amount B as anything other than a loss for taxation purposes, on the ground that it was not a loss in commercial terms. As Lord Hoffmann observed in *MacNiven* [2003] AC 311; (2001) 73 TC 1, at para 58:

"If a transaction falls within the legal description, it makes no difference that it has no business purpose. Having a business purpose is not part of the relevant concept."

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35. As regards the second test, the answer was determined largely by the Special Commissioners' findings of primary fact, and in particular para 5/18 of their decision to which we have referred earlier in this Opinion. He reminded the Court that an appeal lay from the Special Commissioners only on an error of law, and that it was not the function of the Court to re-examine the evidence and to F disturb their findings of primary fact. He relied on the well-known decision of *Edwards (HMIT)* v. *Bairstow & Harrison* [1956] AC 14; (1955) 36 TC 207, and to the speeches of Viscount Simmonds at pp 225-226 and Lord Radcliffe at p 229. In any event, in the present case the Court did not have before it a transcript of the oral evidence and accordingly was unable to know what the witnesses had said on a number of matters such as, for example, the significance, if any, of the reduction of the strike price to 90 and of the descriptions of the scheme which G had preceded the entering into of the transactions on 30 June 1995. It was for the Special Commissioners to decide whether to accept or reject evidence as to what was or was not anticipated at that time. They had not been prepared to accept that they should infer from the evidence that there was a single composite transaction. Mr. Tyre pointed out that Lord Brightman observed in *Furniss* v. *Dawson* [1984] AC 474, at p 528 that, while an appellate court could and should H interfere with an inference of fact which could not be justified by the primary facts, he did not consider that, if the primary facts justified alternative inferences of fact, an appellate court could substitute its own preferred inference for the inference drawn by the fact-finding tribunal. Having decided that there remained the possibility of the non-exercise or separate exercise of an option, it was but a short step for the Special Commissioners to reach the conclusion that I Transactions A and B were separate and did not fall to be treated as parts of a single composite transaction.

36. Mr. Tyre then turned to a number of the criticisms which had been advanced by Mr. Moynihan in regard to "commerciality". It followed from his main submissions that it would have been wrong for the Special Commissioners to ask themselves whether the scheme was not commercial because it had checks and balances written into it. As regards the strike price, what mattered was whether, given that it was 90, there was a genuine commercial possibility that the option under Transaction B would not be exercised. Their decision, based on the evidence, was that the price falling below 90 was

> ". . . unlikely but not so unlikely that one could say that there was no practical likelihood of its occurring, and accordingly that there was a genuine practical likelihood or to put it another way a genuine commercial possibility that the [Respondents] would not exercise Option B." (Para 24)

As regards the Collateral Amount, while it acted as a disincentive to Citibank's exercise of their option, it did not remove the possibility that Citibank would exercise that option at an early stage.

37. Mr. Tyre submitted that the Special Commissioners' reference to "a hedge" in para 32([1]) should be understood in the accountancy sense of a hedge which exactly matched the risk, such as two assets which exactly cancelled out one another. It was not used in same sense in para 27, because the point was that the two options were not identical. The consistent position of the Respondents had been that the option in Transaction B had no tax avoidance purpose but provided a hedge against risk in regard to option A, that is to say the risk of the price of gilts rising above 100. It was for this reason that the Respondents would not have entered into option A on its own. Yet it was only because option B had been granted to remove some of the commercial risk that the Appellants maintained that the transactions should be treated as a single composite transaction.

38. As regards the complaint that the Special Commissioners had failed to address the scheme as a whole, this was not the correct test. The standard contained in FRS5 was irrelevant to this part of the argument. It became relevant only when the conditions for the application of s 155 had been met. If FRS5 was relevant to this part of the argument, what mattered was the possibility of non-exercise or separate exercise, and not the likelihood that the options would be exercised together. In any event, there had been no evidence to support a conclusion as to what was more likely.

39. Mr. Tyre submitted that there was no question of the Special Commissioners having considered likelihood as at the wrong date. The likelihood of non-exercise depended not on the statutory regime but on the life of the option, which was nine months. There was nothing to indicate that the options would be exercised immediately after the statutory scheme came into force. In the event, the fact that the scheme came into force as late as 1 April 1996 almost prevented the options from being exercised. There was no finding that the timing of the coming into operation of the new statutory scheme was not in the mind of the parties as at 30 June 1995. There was nothing to back up the

([1]) Page 554 *ante*.

A assertion that there was an increase from two to nine months in regard to the likely timing of the exercise of the options.

40. Finally, Mr. Tyre submitted, the question whether there was a composite transaction was a tax and not an accountancy question. The Special Commissioners had applied the test enunciated in *Craven* v. *White.* So far as B accountancy practice was concerned, in the context of ss 155 and 156 the question was different and more specific, namely whether the options should be separately marked to market. The answer to the question was, as the Special Commissioners had stated in para 32 of their decision, that having regard to "substance" meant, in the present context, considering the possibility of non-exercise or of separate exercise of the options.

C

41. As we have narrated, the submissions on behalf of both parties sought to harness what was said by the members of the House of Lords in *MacNiven*, namely that it is necessary in the first place to ascertain whether the particular enactment with which this case is concerned embodies a legal or a commercial concept.

D 42. It is clear from s 155 of the 1994 Act that the ascertaining of profit or loss is to be carried out by reference to the particular qualifying contract and particular accounting period. The section does not address the setting off of a profit on one such contract against a loss on the other, or *visa versa.* Next, it is clear that whether there is a profit or loss on a particular qualifying contract for a particular accounting period does not depend on the application of a concept E of profit which is independent of what is provided in the section. Subsections (1) and (2) stipulate what is to be regarded as profit or loss, and require that amount A and amount B are to be ascertained on one or other of two bases; and in the case of the mark to market basis, each of these amounts, and hence the difference between them, depend on changes in value, if any, over the accounting period and payments, if any, due and payable to or by the company in that period.

F

43. In these circumstances we consider that Mr. Tyre was well-founded in submitting that s 155(2) employs a legal concept, being a construct which has a specific statutory meaning. In our opinion the artificial framework for which the section provides does not indicate that a commercial meaning falls to be given to "loss", let alone that the relationship between one qualifying contract and another has to be considered from a commercial viewpoint, in order to determine G whether there was any true "loss".

44. It follows that we reject Mr. Moynihan's approach, which involved ascertaining whether there was a commercial or business purpose rather than tax avoidance for the separate treatment of the transactions which were the components of the scheme. The reference in s 156(3) to "normal accountancy H practice" does not entail that the concept of "loss" for the purpose of s 155 is to be interpreted in accordance with that practice.

45. Even if the concept of "loss" in s 155(2) falls to be treated as a commercial concept, we are not persuaded that Mr. Moynihan was well-founded in submitting that the Special Commissioners were in error in treating I Transactions A and B as separate. This flew in the face of the findings made by the Special Commissioners as to the risks created for Citibank (para 5/12), and

in particular the genuine commercial possibility that due to movements of interest rates and gilt prices, it would be in the interests of Citibank to refrain from exercising Option A or exercising or attempting to exercise it on a date different from the exercise by the Respondents of Option B; and that there was a genuine commercial possibility and a real practical likelihood that the two options would be dealt with separately, and that Option B would not be exercised by the Respondents (para 5/18). These passages are backed up in greater detail by what the Special Commissioners say in paras 24 and 25.

46. Faced with these findings it is not surprising that Mr. Moynihan took the course of criticising the way in which the Special Commissioners had gone about their task, in particular, as he submitted, by failing to consider the scheme as a whole and weigh the implications of its parts, and by creating a false picture of commerciality.

47. We do not consider that the Special Commissioners are to be faulted for applying the test of genuine commercial possibility or practical likelihood, following what was said by Lord Oliver of Aylmerton in *Craven* v. *White*. While there is no doubt that the scheme was intended to avoid tax, it is of some importance to place it in the context of the change in the law which was brought about by the introduction of debt contracts into the category of "qualifying contracts". The essence of the Citibank scheme was to secure the treatment as a loss for tax purposes of the difference between the value of the gilts transferred by the Respondents to Citibank and the price payable by Citibank for those bonds. Because it was not subject to tax either before or after the introduction of the new legislation, the premium which the Respondents received for the granting of Option A could not be brought into account so as to eliminate or reduce that loss. That was a situation created by the drafting of the legislation, which far-sighted observers of the scene decided to turn to their advantage. Option B on the other hand, was not conceived as having any tax advantage to the Respondents. It was not arranged in such a way as to enable them to avoid the taxation of profit or to secure relief against loss. According to the finding of the Special Commissioners it was hedging the risk relating to Option A (para 27). It follows that it was not an essential part of the scheme that Option B should be exercised at the same time as the exercise by Citibank of Option A.

48. We are not persuaded that Mr. Moynihan's submissions relating to the strike price and the Collateral Amount carry weight. As to the first, all that can be taken from the findings of the Special Commissioners is that it was reduced from 95 to 90. Mr. Tyre informed us that in the hearing before the Special Commissioners Mr. Moynihan sought—in vain—to elicit evidence that the reason for the reduction was to ensure that the transactions between the parties were self-cancelling. The Special Commissioners make no finding as to the reasons for the reduction; and there is, in our view, no basis for asking this Court to infer one. As regards the Collateral Amount, it is true that the fact that it was payable entailed that no net sum was paid as at 5 July 1995, apart from the fee of £60,000. However, it is important to bear in mind that the Special Commissioners found that its purpose was to serve as a disincentive to Citibank making an early exercise of Option A. The fact that it was part of the scheme and balanced the interests of the parties during the life of the options does not show that each of the options lacked independent commercial significance. Lastly, we are not impressed with the castigation of the Special Commissioners for having

A suggested a commercial purpose of profit-making. It is clear that the Special Commissioners treated the possibility of taking of a profit as merely incidental or a windfall advantage. The essential purpose of the scheme was and remained to take advantage in the tax position of the premium and the "loss" incurred in the exercise of Option A.

B 49. For these reasons we reject Mr. Moynihan's submissions and hold that the Special Commissioners were correct in treating Transactions A and B separately for tax purposes.

(2) Was each of Transaction A and Transaction B a "qualifying contract" as C at 1 April 1996?

50. In addition to the submissions based on the *Ramsay* approach which we have already discussed, Mr. Moynihan submitted that in any event neither of these transactions came within the scope of s 147A(2). Hence neither fell to be regarded as a "qualifying contract". For that subsection to apply it had to be the D case that the Respondents were entitled to rights, or, as the case might be, subject to duties under the transaction immediately before 1 April 1996. This was not the case.

51. Mr. Moynihan submitted that by 31 March 1996 the transactions had been varied by an agreement constituted by the letters dated 20 and 28 March E 1996, to which we referred in para [10]. The effect of that agreement was that (i) if one option was to be exercised on 1 April 1996, both would be exercised; and (ii) in any event gilts and payments (including the Collateral Amount) would be netted off, so that neither gilts nor money would be delivered by one party to the other. In the result neither transaction gave rise to rights and duties in any meaningful sense: the provisions were self-cancelling, like the charges in the gas F chamber, the image which Lord Wilberforce used in *Ramsay* [1982] AC 300, at p 322. The exercise of neither option resulted in the transfer of gilts or money cf. *HSBC Life (UK) Ltd.* v. *Stubbs (HMIT)* [2002] STC (SCD) 9, at para 25.

52. For the Respondents Mr. Tyre submitted that the letter dated 20 March 1996 changed nothing as a matter of law. It did not constitute the exercise of the G option of Transaction B and made no contractual commitment. It merely expressed an intention in revocable terms. It did not constitute a variation of the contract. The netting off for purposes of settlement was an administrative arrangement in accordance with standard practice under the ISDA agreement which had been referred to in the documents relating to each of the transactions (see the decision of the Special Commissioners at para 9([1])). After midnight on H the morning of 1 April 1996 it was open to either party to change its mind, although in practical terms it was highly unlikely that both options would be exercised. The value of gilts was nowhere near 90, let alone 70.

53. We are not satisfied that to any extent the exchange of letters had the effect of varying the agreement contained in Transactions A and B and,

I

([1]) Page 543 *ante*

accordingly, we reject the view that as at 1 April 1996 it was no longer the case that either party held rights or was subject to duties under either of these transactions. A

(3) Was it appropriate, when applying a mark to market basis to attach a nil value to each option on the morning of 1 April 1996? B

54. By virtue of s 147A(2) the Respondents were deemed to have become entitled to rights and subject to duties under each of the options on 1 April 1996. The Special Commissioners accepted the submission by the Respondents as to the consequence of reading this provision along with ss 155(7) and 177(2)(b). C Under the former, where a qualifying contract "becomes held" by a qualifying company at any time in an accounting period, it is to be assumed for the purposes of s 155(4) that its value is nil immediately after it becomes so held. Under the latter, a company holds such a contract at a particular time if it is then entitled to rights or subject to duties under it. Putting those provisions together the Special Commissioners held at para 41: D

> "It seems to us that since by s 177(2)(b) a company holds a contract at a particular time if it is then entitled to rights or subject to duties under it, it follows that where a company is deemed to have become entitled to rights under a contract on 1 April 1996, the contract is deemed to have become held on that date so as to make s 155(7) applicable." E

55. In attacking this conclusion Mr. Moynihan presented two alternative submissions. The first was that in interpreting s 147A(2) the Special Commissioners had erred in law by failing to carry this deeming provision to its logical conclusion. They had not asked, in the context of s 156(3), how one should account for options which were deemed to have "become held" in April F 1996. They had acted inconsistently by applying s 147A(2) to s 155(7) but not to s 156(3). Since each option was deemed to have "become held" on 1 April 1996, the natural consequence was that that date should be deemed to be the date of grant. He founded on s 177(2)(a) under which a company becomes entitled to rights or subject to duties under a debt contract when it becomes a party to the G contract. The correct approach to s 156(3) was to ask what was the correct accountancy treatment of the option as it stood at the deemed date of grant. The significance of this was that as at 1 April 1996 "everything was a foregone conclusion", since on that date the strict interpretation of the test set out by Lord Oliver of Aylmerton in *Craven* v. *White* would have been satisfied.

H

56. As Mr. Tyre pointed out, there are two significant difficulties created by this submission. The first is that it does not appear to be justifiable to give this extended effect to s 147A(2). So far as s 156(3) is concerned, the value of a contract is dependent upon the application of normal accountancy practice, which the statute does not require to be modified. Secondly, the implication of the argument presented by Mr. Moynihan is that the transitional provisions in I para 25 of Sch 15 to the 1996 Act would have been unnecessary. That paragraph applies to a debt contract or option held immediately before and on 1 April 1996 if the disposal of it on 31 March 1996 would have produced a chargeable gain or a gain which would have been brought into account in the computation of the profits of the trade or business carried on by the company which made the

A disposal. The paragraphs provide for substitution for 1 April 1996 of the commencing day of the first accounting period to end after 31 March 1996.

57. In his alternative submission Mr. Moynihan contended that it was a corollary of the proposition that there was a statute-created loss that it was equally possible for the legislation to have applied to a net profit, for example, if B Transaction B had stood alone.

58. Mr. Moynihan reminded the Court that it could discard an interpretation where the ordinary meaning of words would conflict with the legislative intention, and prefer an alternative interpretation which was consistent with that intention (*Commissioners of Inland Revenue* v. *Luke* [1963] C AC 557; 1963 SC (HL) 65; (1963) 40 TC 630 and *Chevron UK Ltd.* v. *Commissioners of Inland Revenue* (1995) 67 TC 414; [1995] STC 712). A deeming provision could more readily be subject to a purposive interpretation (*Jenks* v. *Dickinson* (1997) 69 TC 458, at pp 487–488). Section 147A(2) should be applied in the context of a legislative scheme which was intended to tax by reference to changes in value and payments. There was something odd about an D interpretation which resulted in tax treatment solely by reference to payments. To have taxed pre-1 April 1996 gains would have represented retrospective taxation.

59. It was possible, he said, to construe s 147A(2) in a manner which avoided that. First, s 155(7) when it was read naturally, applied to a qualifying E contract which was newly acquired, i.e. "it became held", at any time in an accounting period. It was plain that Transactions A and B did not "become held" during the accounting period to 31 December 1996. Secondly, s 147A(2) provided—as did s 147A(1)—when a contract became a "qualifying contract". It could go no further than that. Thirdly, s 177(2)(b) provided that a contract was held over a period during which rights and duties subsisted. There was no need to conflate these three provisions. It was not necessary to leap from para (a) to F (b) in s 177(2), and hence to the decision that the two transactions "became held" on 1 April 1996. It was possible to determine that they were held since 30 June 1995 but became qualifying contracts as at 1 April 1996. Section 155(4) thus applied to the contract as a qualifying contract. The increase or decrease in the value over the period when it was held as a qualified contract, as determined on a mark to market basis, required account to be taken of its opening market value. G There was no need to apply s 155(7) to the acquisition value, since there was no double-counting of acquisition cost. On this basis Mr. Moynihan submitted that in regard to Transaction A the Special Commissioners should have found that there was an increase in value of £34 million for the purposes of s 154(4)(a)(ii), thus reducing the loss to nil; and, in the case of Transaction B, should have found a reduction in value of £14 million for the purposes of s 154(4)(b)(ii), so reducing H the profit to nil.

60. In reply Mr. Tyre submitted that s 177(2) provided the link not only to s 155(7) but to the charging provisions of s 155. Section 155(1) used the word "held", and s 155(7) used the words "becomes held". Section 147A did not use the word "held". It referred instead to "becoming entitled to rights or subject to I duties". This was to tie in with the definition of "contract" in s 150A. Thus far there was a mismatch in terminology. In order to enable the legislation to work, it

was necessary to read s 177(2) along with s 147A(2). The Appellants' contention, which would allow the link to operate wholly selectively, should be rejected. A

61. In our view Mr. Tyre's arguments are compelling and we accept them. In addition they gain support from the existence of the transitional provisions. These include the making of adjustments to Amounts A and/or B in respect of debt contracts held as at the beginning of the account period which "straddled" 1 April 1996. However, there is no provision for debt contracts which are not covered by para 25 in respect that they were exempt from capital gains tax and were held by corporate investors other than traders in gilts and bonds. The argument presented by the Appellants has the remarkable effect of extending transitional provisions beyond the specific scope of para 25 of Sch 15. Accordingly, we reject Mr. Moynihan's submissions under this head of the argument. B C

(4) Was it appropriate to exclude from the computation the Collateral Amount of £20 million? D

62. Mr. Moynihan submitted that the Special Commissioners had erred in law in reaching the conclusion in relation to the scheme that the Collateral Amount was not part of the price of the option under Transaction A. The Special Commissioners found, however, that it consisted of a genuine loan or at least a genuine deposit; that its purpose was to provide Citibank with security and to remove the incentive for Citibank to exercise Option A early; and that there was no right to offset against payments under the options. They rejected the proposition that it formed part of the consideration for Option A, stating that the only consideration was the interest foregone which was neither the payment of an amount within s 150A(5), nor "the transfer of monies worth" within s 150A(11). Standing these findings we do not consider that there is any proper basis for Mr. Moynihan's submissions. E F

63. Having regard to the conclusions which we have reached in the course of this opinion we consider that the appeal is not well-founded and should be refused. We will remit to the Special Commissioners to proceed as accords in regard to any detailed matters which remain to be determined. G

Appeal refused, with expenses.

H

The Crown's appeal was heard in the House of Lords before Lord Nicholls of Birkenhead, Lord Steyn, Lord Hoffmann, Lord Hope of Craighead and Lord Walker of Gestingthorpe on 12 and 13 October, when judgment was reserved. On 25 November 2004, judgment was given in favour of the Crown, with costs.

Graham Aaronson Q.C., and *Colin Tyre, Q.C.* for the Company. I

G J B Moynihan Q.C., David Ewart and *Jane Paterson* for the Crown.

The cases referred to in the speeches are as follows:—*Craven* v. *White* [1989] AC 398; (1988) 62 TC 1; [1988] 3 WLR 423; [1988] 3 All ER 495; [1988] STC 476;

A *W T Ramsay Ltd.* v. *Commissioners of Inland Revenue* [1982] AC 300; (1981) 54 TC 101; [1981] 2 WLR 449; [1981] 1 All ER 865; [1981] STC 174.

The cases cited in the arguments were as follows:—*Barclays Mercantile Business Finance Ltd.* v. *Mawson (HMIT)* [2003] STC 66; *Carreras Group Ltd.* v. *The Stamp Commissioner* [2004] STC 1377; *Chevron UK Ltd.* v. *Inland Revenue* B *Commissioners* [1995] STC 712; *Chinn* v. *Hochstrasser* [1981] AC 533; *Collector of Stamp Revenue* v. *Arrowtown Assets Ltd.* [2003] HKCFA 46; *Commissioners of Inland Revenue* v. *Luke* 1963 SC (HL) 65; *Edwards* v. *Bairstow* [1956] AC 14; (1955) 36 TC 207; [1955] 3 All ER 48; *Furniss* v. *Dawson* [1984] 1 AC 474; *Griffin* v. *Citibank Investments Ltd.* [2000] STC 1010; *Inland Revenue* v. *Burmah Oil Co. Ltd.* 1982 SC (HL) 114; *Inland Revenue Commissioners* v. *Fitzwilliam* [1993] 1 C WLR 1189; *Inland Revenue Commissioners* v. *McGuckian* [1997] 1 WLR 991; *Jenks* v. *Dickinson* [1997] STC 853; *MacNiven* v. *Westmoreland Investments Ltd.* [2003] 1 AC 311; *Moodie* v. *Commissioners of Inland Revenue* (1993) 65 TC 610; *Save Britain's Heritage* v. *Number 1 Poultry Ltd.* [1991] 1 WLR 153; *South Bucks District Council* v. *Porter* [2004] UKHL 33.

D

The Committee (Lord Nicholls of Birkenhead, Lord Steyn, Lord Hoffmann, Lord Hope of Craighead and Lord Walker of Gestingthorpe) have met and considered the cause *Her Majesty's Commissioners of Inland Revenue* (Appellants) v. *Scottish Provident Institution* (Respondents) (Scotland). We have heard counsel on behalf of the Appellants and Respondents.

E

1. The following is the opinion of the Committee to which all its members have contributed.

2. This appeal concerns an artificial scheme devised in 1995 to take advantage of a prospective change in the system of taxing gains on options to buy or sell bonds and government securities ("gilts"). Under the legislation then in F force, the Scottish Provident Institution ("SPI"), as a mutual life office, was not liable to corporation tax on any gain realised on the grant or disposal of such an option. Under the system proposed in an Inland Revenue consultation document published in May 1995, all returns on such options would be treated as income and losses made on disposals would be allowable as income losses.

G

The scheme in outline

3. The central element of the scheme devised by Citibank International plc ("Citibank") to enable SPI take advantage of the change-over was extremely simple. During the old regime, SPI would grant Citibank an option ("the H Citibank option") to buy short-dated gilts, at a price representing a heavy discount from market price, in return for a correspondingly large premium. The premium received on the grant of the option would not be taxable. After the new regime came into force, Citibank would exercise the option. SPI would have to sell the gilts at well below market price and would suffer an allowable loss.

I 4. If that was all there was to the transaction, there would also have been a risk that SPI or Citibank would have made a real commercial profit or loss. The

premium would have been fixed by reference to the current market price, but the possibility of a rise or fall in interest rates during the currency of the option created a commercial risk for one side or the other. Neither side wanted to incur such a risk. The purpose of the transaction was to create a tax loss, not a real loss or profit. The scheme therefore provided for Citibank's option to be matched by an option to buy the same amount of gilts ("the SPI option") granted by Citibank to SPI. Premium and option price were calculated to ensure that movements of money between Citibank and SPI added up to the same amount, less a relatively small sum for Citibank to retain as a fee. In addition, SPI agreed to pay Citibank a success fee if the scheme worked, calculated as a percentage of the tax saving.

5. The calculation of the SPI option price obviously needed careful thought. In one sense, of course, it did not matter. Whatever price was selected would be reflected in the corresponding premium and subsequent movements in the market price would cancel each other out. But the option price for SPI had to be higher than the option price for Citibank, otherwise the "profit" realised by SPI on the exercise of its option would cancel out the "loss" which it suffered on the exercise of the Citibank option and the whole exercise would be futile. Indeed, the greater the difference between the Citibank price and the SPI price, the greater would be the net tax loss created by the scheme. The difference did give rise to a potential cash flow problem because, if Citibank paid the premium for its option, it would be out of pocket in respect of the difference between the two premiums between the date on which the options were granted and the date on which they were exercised. But this was covered by a collateral agreement under which SPI agreed to deposit the difference with Citibank, free of interest, until its option had been exercised or lapsed. This enabled the payment of both premiums to take the form of book entries.

6. On the other hand, the purpose of the SPI option was to reduce or eliminate the possibility that the outcome of the transaction would be affected by events in the real world such as movements in interest rates. So the SPI option price had to be sufficiently below market price as to be, for practical purposes, out of the possible range of such movements. There was also a third consideration. Plainly it was inconceivable that Citibank, having parted with a large premium for its option, would not exercise it. Equally, if the SPI price had been very low, it would have been inconceivable that SPI would not have countered by the exercise of its own option. That might have given rise to a doubt about whether in truth there was any transaction in gilts at all. It would have been inevitable that the obligations of Citibank and SPI to deliver gilts would cancel each other out and that none would change hands. So the SPI option price had to be close enough to the market price to allow for some possibility that this would not happen.

The scheme as implemented

7. The scheme was proposed by Ms. Harrold of Citibank to Mr. Burke, Group Taxation Manager of SPI, in a fax dated 22 June 1995. At that stage, it proposed option or "strike" prices of 95 and 70 (assuming market value on the trade date to be 100) respectively. The scheme as implemented used 90 and 70; a narrower spread which gave SPI a smaller tax loss but provided Citibank with greater security against a commercial loss. The way the scheme would work was

A explained with great clarity by Ms. Harrold in a fax to Mr. Paterson, Senior Corporate Manager of SPI, on 27 June 1995:

"1. The company buys a nine month in-the-money Bermudan style call option contract which gives it the right but not the obligation to purchase 5 year gilts at a strike price of 90, in return for paying an up front premium.

B 2. The company sells a nine month in-the-money Bermudan style call option contract which gives Citibank the right but not the obligation to purchase 5 year gilts at a strike price of 70, in return for paying an up front premium.

C All options are to be settled for physical delivery. The strikes on the options are set at a level assuming that the value of the gilt is 100 on trade date. The style of the options is 'Bermudan' i.e. European for the first 2 months and American thereafter. Both options should be considered as qualifying 'financial options' for the purposes of taxation.

Expected taxation treatment

D The premium received on the call option sold is treated as an exempt capital gain under the current tax regime. Drawing an analogy with the new financial instruments regime, it is conceivable that the premium paid on the option purchased may be added to the purchase price of the bonds when the option is exercised (since no relief has been obtained under the capital gains tax rules).

E After the date of commencement of the new legislation relating to the taxation of gilts and bonds ('commencement date'), the first call option is exercised by the company and immediately afterwards, Citibank exercises the second call option. The purchase and sale of the gilts under the options are netted down within the Central Gilts Office clearing accounts and therefore neither counterparty needs to take delivery of the gilts. The net of the two strikes is paid by the company to Citibank—in the example above F 20.

G The loss on sale of the bonds is expected to be an income expense to the company under the new tax legislation and may be offset against other taxable income. This will be calculated as the sale proceeds of 70 less the cost of purchasing the bonds. If the premium on the option purchased is added to the cost of the bonds (see above), the net loss will be calculated as 30—i.e. 70 less the strike of 90 plus the option premium of 10. The amount of the loss available for offset should be at least the difference between the two strikes on the options—i.e. 90 less 70—in the case that the premium on the option purchased is not added to the cost of the bonds.

H **Collateralisation of premium paid by Citibank to the company**

I The cash paid to the company as the net of the two option premiums (20 in the above example) can be passed back to Citibank as collateral against the exposure to the company. If this cash collateral is interest free, this will enable the options to be priced as American style, i.e. with only intrinsic value and no time value. This means that no funding costs are borne by the company through the option pricing. The collateral is refundable when the option sold to Citibank is exercised, effectively

neutralising the attractiveness of early exercise of the deep-in-the-money American style call option. At the same time, Citibank has cash collateral against its credit exposure to the company. A

The net option premium received by the company is the net intrinsic value of the options i.e. the difference between the two strikes (in our example, 20) and this is also the amount of the net cash which passes back to Citibank on exercise of both the options. B

Citibank NA is pleased to present to you the proposed transaction or transactions described herein. Under no circumstance is it to be considered as an offer to sell, or a solicitation to buy, any investment."

8. At a board meeting held in Dublin on 27 June 1995, SPI's board of directors decided to enter into the scheme as outlined in a paper prepared by the Group Actuary, Mr. Gillon. The board minutes stated: C

"Citibank: Cross Options Scheme. The board received a paper. We were satisfied that we were running no risks other than the cost of the fixed fees involved (£100,000). The tax loss which would be established would be set against future capital gains (which would probably arise within the next few years). The announcement on which it all depended was expected to be made in July and implemented in the Finance Act 1996. There was perhaps only a 50-50 chance of it being successful (it was unlikely that we were the only people who had been approached). Part of the total fee to Citibank was deferred until it was confirmed that the scheme had been successful." D E

9. The formal documents were executed on 30 June 1995. Apart from an elaborate Master Agreement in the standard form produced by ISDA (the International Swaps Dealers Association) which neither side relied on, there were four essential documents: the "transaction A" option agreement (designated no. 1224895), the "transaction B" option agreement (designated no. 1224905), the collateral agreement and the fees letter. These documents contained some elaborate definitions and administrative provisions but their essentials were accurately summarised by the Special Commissioners (in subparas (7), (8), (10) and (11) of para 5 of their written decision—subpara (9) referred to the ISDA Master Agreement) as follows (but slightly amended to avoid repetition): F G

"(i) Under transaction A, the taxpayer company granted a call option to Citibank in respect of £100 million of nominal amount of 8 per cent. UK gilts due 7 December 2000 at an option strike price of 70 per cent. of the par value of the bond plus accrued interest. The option was exercisable at any time between 30 August 1995 and 1 April 1996. The premium for the option was £29.75 million payable to the taxpayer company on 5 July 1995. Provision was made for notice of exercise of the option to be given. If the option were to be exercised, then settlement was to be 'physical' i.e. the bonds were to be delivered in exchange for payment. H

(ii) Under transaction B, Citibank granted a call option to the taxpayer company in respect of £100 million of nominal amount of 8 per cent. UK gilts due 7 December 2000 at an option strike price of 90 per cent. of the par value of the bond plus accrued interest. The option was exercisable at any time between 30 August 1995 and 1 April 1996. The premium for the option was £9.81 million payable by the taxpayer company I

A on 5 July 1995. Provision was made for notice of exercise of the option to be given. If the option were to be exercised then settlement was to be 'physical', i.e. the bonds were to be delivered in exchange for payment.

(iii) Under the collateral agreement, the taxpayer company [was] required to pay Citibank on 5 July 1995 the collateral amount, defined as 'an amount of Pounds Sterling equal to the Bond Entitlement of Transaction A B multiplied by the difference between the Option Strike Price of Transaction A and the Option Strike Price of Transaction B'. This amounted to £20 million. Under the agreement, it fell to be repaid, without interest, on the earlier of the day on which Transaction A was exercised and 1 April 1996.

(iv) The [Structuring Fee Agreement] entitled Citibank to a structuring fee calculated by reference to the taxpayer company's long term business C funds including and excluding the two option contracts, less the initial fee of £60,000, and subject to a maximum of £240,000. The maximum total fee was thus £300,000. The agreement provided for payment on 1 September 1996."

10. It will be apparent that the stated consideration for option A exceeded D the stated consideration for option B by £60,000 less than £20 million. The sum of £60,000 was Citibank's minimum fee, to be retained even if the scheme failed to save tax. The Special Commissioners accepted Ms. Harrold's evidence that Citibank regarded the minimum fee as including the cost of hedging the risk Citibank was undertaking. The Special Commissioners also found (para 5 (12)):

"These option contracts created a genuine economic risk for Citibank. E That risk was passed to Citibank, Frankfurt. Citibank, Frankfurt managed a pool of options to which the said two options were added. Citibank's bond option trading activities and risk management took place at Citibank, Frankfurt."

F However, the £60,000 stayed in Citibank International plc. That appears from Ms. Harrold's "booking summary" prepared on 3 July 1995. This document (written when the timing of the new legislation was still uncertain) repeated almost word for word what had been stated in the proposal sent to SPI on 27 June:

"After the date of commencement of the new legislation relating to the G taxation of gilts and bonds, the first call option is exercised by Scottish Provident and immediately afterwards Citibank exercises the second call option. The purchase and sale of the gilts under the options are netted down within the Central Gilts Office ('CGO') clearing accounts and therefore neither counterparty needs to take delivery of the gilts. The payment for the gilts on exercise of the options are also netted by the CGO."

H

11. On 12 July 1995 Mr. Burke wrote an internal memorandum commenting on the Inland Revenue press release which had been put out two days before. The last date for exercise of the options was 1 April 1996, and it appeared from the press release that this was to be the date on which the new tax regime would start to apply to SPI. Mr. Burke observed in his memorandum:

I "The options themselves would also have to be exercised on 1 April 1996 in order to generate tax losses on the first day of the new rules. We will

have to wait until the transitional rules are published to see if we have a chance of retaining these losses. A

Holding the options until 1 April 1996 introduces two further issues: one for SPI and one for Citibank.

First, the options will be held over the year end and we will have to be satisfied that the accounting treatment, and disclosure, in the statutory accounts and returns does not have any adverse implications for either tax, or commercial purposes. B

Second, we are extending the period over which there is a potential investment risk for Citibank. If the price of the underlying gilt drops below 90% of its nominal value SPI begin to make a profit on the arrangement. This is because the cost of satisfying SPI's obligation under the option we have written is less than the net premium received. Ultimately, the profit could be £20 m in the extreme case where the price of the underlying gilt drops below 70% of its nominal value." C

12. There are no further relevant documents before the House until a letter which Mr. Paterson wrote to Ms. Harrold on 20 March 1996, as follows: D

"This is to let you know that we presently expect to exercise our option under transaction B on 1 April 1996. This is not formal notice of such exercise except in the circumstances considered in the third paragraph below. However, it may facilitate settlement to discuss consequences now. E

If, as seems likely, the option under transaction A is also exercised (by Citibank) on 1 April 1996, I would suggest that we agree in terms of section 2 (c) of the ISDA Master Agreement that stock deliveries and all sums due (including the £20 m collateral deposit under transaction A) be netted off for settlement purposes. The result would be that neither stock nor money would be exchanged between us. F

In the absence of our further instructions otherwise, please note that if Citibank does exercise its option under transaction A on 1 April 1996 then you should consider this paragraph to constitute notice by Scottish Provident Institution of exercise of its option under transaction B also on 1 April 1996. G

Please confirm that the above proposals are acceptable and let me know any other matters which you think may usefully be considered before 1 April."

13. Ms. Harrold replied by fax on 28 March. She confirmed that if on 1 April both options were exercised, stock deliveries and sums due (including the £20 million collateral deposit) would be netted off H

". . . with the result that neither stock nor money would be exchanged between us. Moreover, as there will be no requirement for settlement through the CGO there is no need for either Citibank or Scottish Provident to issue instructions regarding settlement to the CGO nor notify the CGO in any other respect of the exercise of the above transactions." I

She also stated that if SPI exercised its option on 1 April "then you should consider this paragraph to constitute notice by Citibank of exercise of its option under transaction A also on 1 April 1996."

A 14. On 1 April 1996 Mr. Paterson faxed to Ms. Harrold:

"We hereby exercise our option.

I note that per your letter of 28 March 1996 your option under transaction ref 1224895 is also exercised.

Settlement is agreed to be by offset per your letter of 28 March 1996 and B my letter to you of 20 March 1996."

Ms. Harrold replied by fax:

"I confirm receipt of your fax this morning notifying exercise of your option and accepting consequent exercise of our option under our letter of 28 March 1996. I confirm that settlement is to be by offset as per our letter C of 28 March 1996 and your letter of 20 March 1996."

15. Despite Mr. Burke's note as to the need for caution SPI made an accounting error in reporting its results for 1995. The Special Commissioners (para 8) described it as follows:

D "Because of an error caused by the absence of values for the options in the investment summary, the asset of the collateral deposit but not the net liability of the options was included in the accounts, resulting in an overstatement of assets by £20 million. This was discovered when the Department of Trade and Industry return was made. The auditors agreed that the error was not material."

E

The Special Commissioners

16. The Special Commissioners (Mr. J Gordon Reid Q.C. and Dr. John F Avery Jones CBE) gave a detailed written decision (reported at [2002] STC F (SCD) 252) which began by summarising the course of the hearing, and the scheme in outline. Then para 5 (headed "Principal findings-in-fact") contained 19 sub paragraphs, some of which have already been quoted. Parts of para 5 contained, not only findings of primary fact, but also evaluative findings; and there were more evaluative findings in later paragraphs. The most important of these are as follows:

G (i) Paragraph 5 (18):

"Transactions A and B were entered into by the Appellant and Citibank acting at arm's length. The options and premia payable were negotiated at market rates. When transactions A and B were entered into along with the Collateral Agreement, there was a genuine commercial possibility of movement of interest rates and gilt prices H such that it would be in Citibank's commercial interests to either refrain from exercising Option A or exercising or attempting to exercise it on a date different from the exercise by the Appellant of Option B. There was a genuine commercial possibility and a real practical likelihood that the two options would be dealt with separately. Likewise, there was a genuine commercial possibility and a real I practical likelihood that Option B would not be exercised by the Appellant."

It will be apparent that these observations assume that Citibank and SPI were at liberty to act as either thought fit in relation to its option, regardless of the terms of the scheme which Citibank had sold to SPI. The Special Commissioners returned to this point in para 26 (below). A

(ii) (Paragraphs 22, 24, 25):

"The options are therefore self-cancelling if there is no practical likelihood or no genuine commercial possibility of the price falling below 90 . . . Our decision, based on this evidence, is that the price falling below 90 was unlikely but not so unlikely that one could say that there was no practical likelihood of its occurring, and accordingly that there was a genuine practical likelihood or to put it another way a genuine commercial possibility that the Appellant would not exercise Option B . . . It follows that there was a genuine practical likelihood or a genuine commercial possibility that the Appellant would not exercise Option B. The result would be that the Appellant would make a profit and Citibank a loss. B C

We consider that, while it is near the limit, this degree of uncertainty saves the transactions from being ignored for tax purposes . . . They were genuine transactions under which the parties could make a profit or loss even though the expectation was that they would not." D

(iii) (Paragraph 26):

"There was no agreement that the options would not be exercised early. Each party was free to exercise the options if it wanted." E

(iv) (Paragraph 28):

"We find that the Collateral Agreement is separate from the two options. It consisted of a genuine loan or at least a genuine deposit. Its purpose was to provide Citibank with security and to remove the incentive for Citibank to exercise Option A early. There was no right to offset it against payments under the options." F

(v) (Paragraph 39):

"The Collateral Agreement is clearly linked to the options but it is a separate agreement making a loan or deposit that is not part of the options." G

(vi) (Paragraph 40):

"Mr. Moynihan argues that because of the agreement to net off made on 28 March 1996 there were no subsisting rights and duties under the options. We do not agree. The agreement to net off said merely that if both parties exercised their options, then neither stock nor money would be exchanged, and if the Appellant did exercise its option then Citibank should be taken to have exercised its option. Both options continued in place and although, by 28 March 1996, both parties expected to exercise their options, their rights and duties under the two options continued to subsist." H I

The Special Commissioners thus made a finding of fact, which a court hearing an appeal on a question of law is not entitled to disturb, that there was an outside but commercially real possibility that circumstances might occur in

A which the two options would not be exercised so as to cancel each other out. The question of law is whether, in a case in which they were in fact exercised so as to cancel each other out, the existence of this contingency prevented the Commissioners from applying the statute to the scheme as it was intended to operate and as it actually did operate. The Commissioners thought that it obliged them to treat the options as separate transactions.

B

The Inner House

17. The Inner House of the Court of Session (the Lord President (Cullen), Lady Cosgrove and Lord Eassie) dismissed the Inland Revenue's appeal in a reserved opinion of the Court delivered by the Lord President ([2003] STC 1035, C 1056). The Court rejected the Inland Revenue's criticisms of the Special Commissioners' findings and reasoning.

The question of construction

18. SPI is entitled to treat the loss suffered on the exercise of the Citibank D option as an income loss if the option was a "qualifying contract" within the meaning of s 147(1) of the Finance Act 1994. Section 147A(1) (inserted by the Finance Act 1996) provides that a "debt contract" is a qualifying contract if the company becomes subject to duties under the contract at any time on or after 1 April 1996. By s 150A(1) (also inserted by the Finance Act 1996) a "debt contract" is a contract under which a qualifying company (which means, with E irrelevant exceptions, any company: see s 154(1)) "as any entitlement . . . to become a party to a loan relationship". A "loan relationship" includes a government security. So the short question is whether the Citibank option gave it an entitlement to gilts.

19. That depends upon what the statute means by "entitlement". If one confines one's attention to the Citibank option, it certainly gave Citibank an F entitlement, by exercise of the option, to the delivery of gilts. On the other hand, if the option formed part of a larger scheme by which Citibank's right to the gilts was bound to be cancelled by SPI's right to the same gilts, then it could be said that in a practical sense Citibank had no entitlement to gilts. Since the decision of this House in *W T Ramsay Ltd.* v. *Inland Revenue Commissioners* [1982] AC 300 it has been accepted that the language of a taxing statute will often have to G be given a wide practical meaning of this sort which allows (and indeed requires) the Court to have regard to the whole of a series of transactions which were intended to have a commercial unity. Indeed, it is conceded by SPI that the Court is not confined to looking at the Citibank option in isolation. If the scheme amounted in practice to a single transaction, the Court should look at the scheme as a whole. Mr. Aaronson Q.C., who appeared for SPI, accepted before the H Special Commissioners that if there was "no genuine commercial possibility" of the two options not being exercised together, then the scheme must fail.

Applying the construction

20. Mr. Aaronson submitted, as had been argued successfully before the I Special Commissioners and the Inner House, that even if the parties intended that both options should be exercised together, as contemplated in Ms. Harrold's

memorandum of 27 June 1995, the Court could treat them as a single transaction only if there was "no practical likelihood" that this would not happen. On this point, SPI has the benefit of the findings of fact by the Special Commissioners to which we have referred in para 16 above. The Commissioners adopted (at para 24) the analogy of horserace betting:

> "If the chance of the price movement occurring was similar to an outsider winning a horse race we consider that this, while it is small, is not so small that there is no reasonable or practical likelihood of its occurring; outsiders do sometimes win horse races."

21. Mr. Aaronson said that a test of "no practical likelihood" derived from the speech of Lord Oliver of Aylmerton in *Craven* v. *White* [1989] AC 398, at p 514 and assented to by Lords Keith of Kinkel and Jauncy of Tullichettle. In that case, however, important parts of what was claimed by the Revenue to be a single composite scheme did not exist at the relevant date. As Lord Oliver said (at p 498):

> [T]he transactions which, in each appeal, the Inland Revenue seeks now to reconstruct into a single direct disposal from the taxpayer to an ultimate purchaser were not contemporaneous. Nor were they pre-ordained or composite in the sense that it could be predicated with any certainty at the date of the intermediate transfer what the ultimate destination of the property would be, what would be the terms of any ultimate transfer or even whether an ultimate transfer would take place at all."

22. Thus there was an uncertainty about whether the alleged composite transaction would proceed to completion which arose, not from the terms of the alleged composite transaction itself, but from the fact that, at the relevant date, no composite transaction had yet been put together. Here, the uncertainty arises from the fact that the parties have carefully chosen to fix the strike price for the SPI option at a level which gives rise to an outside chance that the option will not be exercised. There was no commercial reason for choosing a strike price of 90. From the point of view of the money passing (or rather, not passing), the scheme could just as well have fixed it at 80 and achieved the same tax saving by reducing the Citibank strike price to 60. It would all have come out in the wash. Thus the contingency upon which SPI rely for saying that there was no composite transaction was a part of that composite transaction; chosen not for any commercial reason but solely to enable SPI to claim that there was no composite transaction. It is true that it created a real commercial risk, but the odds were favourable enough to make it a risk which the parties were willing to accept in the interests of the scheme.

23. We think that it would destroy the value of the *Ramsay* principle of construing provisions such as s 150A(1) of the 1994 Act as referring to the effect of composite transactions if their composite effect had to be disregarded simply because the parties had deliberately included a commercially irrelevant contingency, creating an acceptable risk that the scheme might not work as planned. We would be back in the world of artificial tax schemes, now equipped with anti-*Ramsay* devices. The composite effect of such a scheme should be considered as it was intended to operate and without regard to the possibility that, contrary to the intention and expectations of the parties, it might not work as planned.

A 24. It follows that in our opinion the Special Commissioners erred in law in concluding that their finding that there was a realistic possibility of the options not being exercised simultaneously meant, without more, that the scheme could not be regarded as a single composite transaction. We think that it was and that, so viewed, it created no entitlement to gilts and that there was therefore no qualifying contract.

B

25. Mr. Aaronson submitted that SPI have merely taken legitimate advantage of a gap in the transitional provisions of the 1996 Act. Paragraph 25 of Sch 15 has the effect of preventing a company from claiming that a loss made after 1 April 1996 as a result of the exercise of an option granted before that date is an income loss. But it applies only to companies which would have been liable to tax before 1 April 1996 if the transaction had produced a gain: see para
C 25(1)(b). SPI was not so liable and Mr. Aaronson submits that it was entitled to order its affairs to take advantage of its position.

26. It may be that if the Citibank option had stood alone, it would have been a qualifying contract and SPI would have sailed through the gap. Mr. Moynihan Q.C., for the Inland Revenue, advanced a number of arguments of a
D more or less technical nature which he said would have prevented this from happening. But we need not discuss these points because SPI chose to enter into arrangements which, viewed as a whole, did not create a qualifying contract at all. On this ground we would allow the appeal.

Appeal allowed, with costs in the House of Lords and expenses in the Court
E *of Session.*

[Solicitors: Solicitor of Inland Revenue and Solicitor (Scotland), Inland Revenue; Maclay Murray & Spens.]

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