TRANSACTIONS IN SECURITIES – share buy-backs - trustees of exempt approved scheme purchased shares in Powergen which subsequently bought back the shares – trustees claimed tax credit - whether the scheme received an abnormal amount –no - whether the scheme obtained a tax advantage – yes – whether the sales back to Powergen were transactions carried out for bona fide commercial reasons or in the ordinary course of making or managing investments – yes - whether a main object of the sales was to enable tax advantages to be obtained - yes – appeal allowed – Taxes Act 1988 ss703, 704 and 709

THE SPECIAL COMMISSIONERS

THE TRUSTEES OF THE OMEGA GROUP PENSION SCHEME

Appellants

- and -

THE COMMISSIONERS OF INLAND REVENUE

Respondent

SPECIAL COMMISSIONERS : DR NUALA BRICE

MALACHY CORNWELL-KELLY

Chairman's name: use right arrow to move to starting point after this box

Sitting in London on 26, 27, 28 and 29 March 2001

John Gardiner QC with Jolyon Maugham of Counsel, instructed by Messrs Lovells, Solicitors, for the Appellants

Launcelot Henderson QC with Christopher Tidmarsh of Counsel, instructed by the Solicitor of Inland Revenue, for the Respondent

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ANONYMISED DECISION

The appeal

1. The Trustees of the OMEGA Group Pension Scheme (the Appellants) appeal against a notice and an assessment.

2. The notice was dated 18 November 1999 and was given by the Board of Inland Revenue under section 703(3) of the Income and Corporation Taxes Act 1988 (the 1988 Act). The notice stated that section 703 applied to the Appellants in respect of two transactions, namely two sales of shares in Powergen Plc (Powergen) to Powergen. The first sale was on 16 May 1996 and the second on 5 June 1996. The notice also stated that an assessment to income tax under

Schedule F for the year 1996/97 for receipts of £484,563.00 was requisite for counteracting the tax advantages obtained by the two transactions.

3. The assessment was notified to the Appellants on 15 December 1999 and assessed tax of £96,912.60 in respect of the assessable receipts of £484,563.00.

The legislation relating to the issues

4. The relevant parts of section 703 of the 1988 Act provide:

"703(1) Where-

(a) in any such circumstances as are mentioned in section 704, and

(b) in consequence of a transaction in securities or of the combined effect of two or more such transactions,

a person is in a position to obtain, or has obtained, a tax advantage, then unless he shows that the transactions were carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments, and that none of them had as their main object, or one of their main objects, to enable tax advantages to be obtained, this section shall apply to him in respect of that transaction or those transactions. ...

(3) Where this section applies to any person in respect of any transaction or transactions, the tax advantage obtained or obtainable by him in consequence thereof shall be counteracted by such of the following adjustments, that is to say an assessment on such basis as the Board may specify by notice served on him as being requisite for counteracting the tax advantage so obtained or obtainable."

5. Section 703(1)(a) refers to "such circumstances as are mentioned in section 704". The parts of section 704 which are relevant in this appeal are:

"704A. That in connection with the distribution of profits of a company, or in connection with the sale or purchase of securities being a sale or purchase followed by a purchase or sale of the same or other securities, the person in question receives an abnormal amount by way of dividend, and the amount so received is taken into account for any of the following purposes:

(a) any exemption from tax ..."

6. The relevant parts of section 709(2) provide:

"709(2) In this Chapter: ...references to dividends include references to other qualifying distributions and to interest."

7. The relevant parts of section 709(4) provide:

"709(4) For the purposes of section 704 an amount received by way of dividend shall be treated as abnormal if the Board, the Special Commissioners or the tribunal, as the case may be, are satisfied: ...

(b) in any case, that it substantially exceeds a normal return on the consideration provided by the recipient for the relevant securities, that is to say, the securities in respect of which the dividend was received ...."

8. The relevant parts of section 709(6) provide:

"709(6) For the purposes of subsection (4)(b) above- ...

(b) in determining whether an amount received by way of dividend exceeds a normal return, regard shall be had to the length of time previous to the receipt of that amount that the recipient first acquired any of the relevant securities and to any dividends or other distributions made in respect of them during that time."

9. Section 703(1) also refers to the obtaining of "a tax advantage". Section 709 defines the meaning of tax advantage and other expressions. Section 709(1) provides:

"709(1) In this chapter "tax advantage" means a relief or increased relief from, or repayment or increased repayment of, tax, or the avoidance or reduction of a charge to tax or an assessment to tax or the avoidance of a possible assessment thereto, whether the avoidance or reduction is affected by receipts accruing in such a way that the recipient does not bear tax on them, or by a deduction in computing profits or gains."

The issues

10. The Appellants purchased shares in Powergen. On two occasions they sold the shares back to Powergen and claimed tax credits. The Inland Revenue were of the view that the circumstances of the sales were as mentioned in section 704A because the Appellants had received an abnormal amount by way of dividend and were also of the view that the Appellants had obtained a tax advantage. The Appellants argued that the circumstances were not as mentioned in section 704A as they had not received an abnormal amount. They also argued that they had not obtained a tax advantage. Finally, they argued that the two sales were carried out for bona fide commercial reasons and in the ordinary course of making or managing investments and that neither of them had as their main object, or one of their main objects, to enable tax advantages to be obtained.

11. Thus the issues in the appeal were:

(1) whether section 703(1)(a) applied and whether the circumstances were as mentioned in section 704 and, in particular, whether the Appellants received an abnormal amount within the meaning of section 704A as clarified by sections 709(2), 709(4)(b) and 709(6)(b);

(2) whether section 703 applied and, in particular, whether the Appellants obtained a tax advantage as defined in section 709(1);

(3) whether the sales were carried out for bona fide commercial reasons or in the ordinary course of making or managing investments within the meaning of section 703(1); and

(4) whether the sales had as their main object, or one of their main objects, to enable tax advantages to be obtained within the meaning of section 703(1).

The evidence

12. A statement of agreed facts and accompanying documents were produced. Three bundles of documents were produced on behalf of the Appellants being: (1) documents; (2) procedural documents; and (3) a witness statement and exhibits of Mr Keith Richard Mullins. Oral evidence was given on behalf of the Appellants by Mr Mullins. Mr Mullins is the fund manager of the OMEGA Group Pension Scheme at Merrill Lynch Investment Managers Limited (formerly Mercury Asset Management (MAM)). Mr Mullins joined the Mercury Group in 1978 and has been a fund manager for 20 years. Throughout that time he was involved in the UK pension business of MAM. He became the UK equity fund manager of the Appellant's portfolio in 1994. A witness statement dated 9 March 2001, and made the Secretary of the Appellants, was not objected to by the Inland Revenue and was put in evidence at the hearing of the appeal without the attendance of the Secretary.

The facts

13. From the evidence before us we find the following facts.

The Appellants, the scheme and the investment powers

14. The OMEGA Group (OMEGA) is a publicly quoted company which appears in the FTSE 100. It trades in computer software. In about 1949 Yarrow Limited, which later became OMEGA, established a pension scheme (the scheme) for its employees and the Appellants are the trustees of the scheme. In 1996 the value of the assets of the scheme varied between £60 million and £66 million. The scheme is an exempt approved scheme within the meaning of section 592 of the 1988 Act which provides:

"592(2) Exemption from income tax shall, on a claim being made in that behalf, be allowed in respect of income derived from investments or deposits if, or to such extent as the Board are satisfied that, it is income from investments or deposits held for the purposes of the scheme."

15. Schemes such as that of which the Appellants are trustees, whose income is exempt from income tax, were referred to at the hearing as "gross funds".

16. The Appellants receive contributions from both OMEGA and its employees and pay pensions to those entitled to them. The Appellants also have responsibility for the investment of the funds of the scheme. On 6 August 1982 the Appellants first appointed MAM as the discretionary fund manager of the scheme and delegated to MAM their responsibility for the investment of the funds of the scheme.

The managing of the investments by MAM

17. The MAM Group currently employs over 260 investment professionals who provide investment management services for institutional and private clients. It was acquired by Merrill Lynch & Co Inc in December 1997 and is now a major global asset management company with over US$460 billion of assets under management. Clients include pension funds, companies, private clients and charities. As at March 1997 MAM's clients included 5 of the 10 largest pension funds in the world and the pension funds of over 50 of the UK's 100 largest quoted companies or their subsidiaries.

18. The appointment of MAM by the Appellants, which was in force at the date of the two sales the subject of this appeal, was dated 6 July 1991 and gave MAM sole responsibility for the management of the assets of the scheme. MAM was authorised to carry out investment transactions without reference to the Appellants. The scheme set MAM's performance target which implied a total return objective for the UK equity portfolio of between 0.5% and 1.5% per annum above the FT All Share Index (the Index). No distinction was made between capital and income flows.

19. In addition, MAM had a fiduciary obligation to invest properly and had obligations to its regulatory authority (formerly IMRO and now the Financial Services Authority). IMRO published Conduct of Business Rules, section 3 of Chapter II of which dealt with dealing, managing and advising. Paragraph 3.8(1)(d)(i) provided that a firm had to take reasonable care to obtain the price which was the best available for the customer in the relevant market at the time for transactions of the kind and size concerned. This was referred to as the "best execution" rule.

MAM's approach to individual funds

20. MAM sought to achieve its performance target by active fund management and individual stock selection. The target of out-performing the Index was achieved by holding overweight positions in stock which it was thought would out-perform the Index; holding underweight positions in stock which it was thought would under-perform the Index; and by not holding certain stocks at all. Fund managers would purchase stocks which they expected to out-perform the market by a significant extent and would sell stocks which they expected to under-perform the market.

21. For each discretionary client MAM first decided an asset allocation which determined how much of a fund should be allocated to equity or bond markets. This was decided centrally. Individual fund managers were then given responsibility for managing each segregated equity or bond portfolio. Within each equity market there were guidelines as to how much of a client's assets should be invested in each of the major sectors, one of which was utilities. A UK equity portfolio for a scheme was usually made up of between 40 and 70 equities. (At the end of 1995 the OMEGA scheme held just over 40 UK equities whereas the Index contained 848 stocks.)

22. Although each fund manager relied heavily on MAM's research process he was not compelled to follow any individual recommendation. Fund managers held weekly meetings when they considered, among other things, research reports on particular sectors prepared by research staff at MAM. Fund managers also considered external research documents.

Mr Mullins' responsibility for the scheme

23. Mr Mullins was the fund manager at MAM who was responsible for the scheme's UK equity sector. At the relevant time he was also responsible for managing the UK equity sector of about twelve other exempt funds. He did not have any non-exempt clients. Mr Mullins was also the leader of the Alpha team at MAM the members of which team managed medium-sized pension funds like OMEGA. There were about six or eight other members of the team and they met each week. Mr Mullins also attended daily morning meetings which received reports of company news and gave quick reactions. We accept the evidence of Mr Mullins that, although fund managers considered a great deal of information,

actual decisions to buy or sell were made by individual fund managers exercising their own judgment.

24. The MAM guidelines indicated that electricity should be 2% of the UK equity sector. However, as at 29 December 1995, the scheme held no investment in the electricity sector even though that was 3.3% of the Index. We accept the evidence of Mr Mullins that on the whole he did not like utilities which were mature stocks with low growth. Also, in the middle of 1995, electricity generating companies were under-performing the Index and there was always a risk of regulatory intervention.

September 1995 - Powergen's bid for Midlands Electricity

25. Powergen is one of the two main generators of electrical power in the UK. On 18 September 1995 Powergen made a £1.8 billion offer (the bid) to acquire Midlands Electricity Plc (Midlands) which was a regional electricity company.

26. The bid gave rise to discussion about Powergen in the research documentation available to Mr Mullins. We give three examples. On 19 September 1995 Lehman Brothers commented that the acquisition of Midlands would result in a material improvement in shareholder value for Powergen but that, even if Powergen were prevented from acquiring Midlands, it could still choose to use its balance sheet strength to fund a share re-purchase scheme. A take-over "would add significantly to the underlying value of the group" but a share re-purchase, while enhancing shareholder value, was "a form of financial engineering which winds down the asset base of the company and would not necessarily add to its long term development." The document concluded that Powergen was expected to out-perform the market by between 5 and 15 percentage points. An internal MAM note dated 21 September 1995 about Powergen reported on the bid for Midlands and the disposal of two plants to Eastern Electricity and said that the deal was likely to enhance earnings by more than a share buy-back (12 per cent versus 7 per cent). A paper issued by Morgan Stanley on 19 October 1995 concluded that Powergen's share price weakness was excessive and gave a "strong buy" recommendation.

27. On 23 November 1995 the President of the Board of Trade referred the bid to the Monopolies and Mergers Commission (the Commission). Although the market anticipated that the bid would be cleared the share price dropped at the time of the referral. There was some comment in The Times on 13 January 1996 which indicated that it was expected that the bid would be cleared by the Commission but that, if the bid were not cleared, there would be "a lot of cash looking for a home which could mean share buybacks".

February and March 1996 – the sceme's purchase of the Powergen shares

28. We accept the evidence of Mr Mullins that, after the announcement of the bid, he liked Powergen because of the prospect of real growth if the bid went ahead. The bid offered the prospect of vertical integration in the power market, with electricity generation and distribution combined in one company. MAM was of the view that, if the offer were successful, Powergen's earnings would be substantially enhanced and that this would be reflected in the price of its shares. That meant that a holding of such shares would out-perform the Index.

29. Accordingly, on 26 February 1996 MAM purchased for the Appellants 100,000 50p ordinary shares in Powergen at the price of £5.39 per share. On 7 March 1996 it purchased for the Appellants 20,000 more ordinary shares in the same

company at the price of £5.35 per share. These were normal purchases of quoted shares in the open market at prevailing prices.

30. We accept the evidence of Mr Mullins that share buy-backs were common in the utilities sector and that they were a means of reducing equity and debt levels and enhancing the value of the remaining shares. Mr Mullins was also aware that a gross fund which participated in a buy-back would obtain a tax credit for the shares sold as well as the enhancement of any shares it retained. However, we also accept his evidence that he would never buy a share just in order to participate in a buy-back. It was never possible to sell the whole of a holding into a buy-back; buy-backs were always limited to a percentage of the shares and were heavily over-subscribed. We also accept the evidence of Mr Mullins that generally he only bought for long-term growth and did not like excessive activity. The shares were purchased for the scheme because he was of the view that they would be a good investment for the scheme; the buy-back was not the primary reason for the purchase and MAM hoped that the bid would proceed. Accordingly we find that, although Mr Mullins was aware of the possibility of a buy-back, that was not the reason why he bought the shares.

31. After the purchase the scheme's holdings in the electricity sector was 2.3% against the sector as a percentage of the Index of 3.3%. Thus the scheme's holding was in line with the MAM guidelines that electricity should be 2% of the UK equity sector.

32. On 13 April 1996 The Economist leaked a report that the Commission had cleared the bid and the share price rose. The report was formally released on 25 April 1996. However, on 24 April 1996 the President of the Board of Trade decided to reject the recommendation of the Commission and to block the bid and the share price fell. On 25 April 1996 the Daily Telegraph reported that Powergen would challenge the decision of the President of the Board of Trade by way of an application for judicial review and so there was no immediate wide-scale selling of the shares. At this stage Mr Mullins had not decided to sell the shares; he still hoped that the bid would go through. However, on 14 May 1996 Powergen announced that it had disposed of the its shares in Midlands.

May and June 1996 – the sale of the shares back to Powergen

33. This signalling of the abandonment of the bid and of Powergen's integration plans led Mr Mullins to conclude that Powergen was a less attractive investment. However, he did not want to "dump" the Powergen shares in the market as it was difficult to shift so many shares at once. At that time MAM held 31,635,820 Powergen shares for all its clients.

34. The next day, on 15 May 1996, Powergen made an announcement in relation to its preliminary results. The announcement included an indication of its intention to utilise the proceeds of the sale of its shares in Midlands to finance the re-purchase (buy-back) of about 10% of its share capital in the coming months. On 16 May 1996 Powergen offered to re-purchase on the Stock Exchange 4.8% of its fully paid issued capital (the first buy-back). The announcement indicated that, in certain circumstances, benefits which might otherwise arise from treatment of part of the sale price as distribution income with an associated tax credit might be counter-acted by the Inland Revenue under section 703 of the 1988 Act.

35. A feature of the buy-back was that it was published on all screens and all dealers were aware of the offer but there was very little time for holders of shares to consider whether they wished to participate. The announcement was made at

14:41 on 16 May and by 17:22 on the same day the buy-back was complete. The price was fixed by Powergen and the shares were offered to the market at a price which was close to the prevailing market price at that time.

36. Mr Mullins told us that he regarded his purchase of Powergen shares as a mistake. His reason for buying them, namely the proposed vertical integration, did not materialise. When the buy-back was announced he appreciated that the purchase price announced by Powergen together with the associated tax credit provided an opportunity to achieve a sale of the shares held for the scheme at a price which was considerably in excess of his targets. He was obliged under the best execution rule to get the best price for his clients. He was aware of the intentions of the Inland Revenue as stated in the announcement of 16 May 1996 but he wanted to sell the shares for good investment reasons and considered that the buy-back was a good opportunity to do that. Accordingly, the scheme participated in the first buy-back and tendered the whole of its holding. Part only was accepted and MAM sold that part to Powergen. On 16 May 1996 45,000 shares were sold for £5.25 per share (£236,250).

37. A further announcement was made by Powergen on 5 June 1996 similar to that of 16 May. The announcement said that Powergen would purchase more shares to bring the total re-purchased up to 10% (the second buy-back). There had been no material change since the first buy-back of 16 May and so for the same reasons the scheme participated in the second buy-back. On 5 June 1996 40,162 shares were sold for £4.83 per share (£193,982).

38. We were shown a summary of MAM's holdings of shares in Powergen and dealings in them from 1 March 1996 to 1 August 1996. Before 15 May 1996 most of the transactions were purchases and after than date most were sales. Most of the sales were on behalf of gross funds. We accept the evidence of Mr Mullins that the participation by MAM in the buy back was allocated pro rata to fund managers who wanted to sell on behalf of their clients. As Mr Mullins only acted for gross funds he allocated his allocation between those gross funds.

39. After participating in the two buy-backs MAM still held 34,838 Powergen shares for the scheme. On 24 July 1996 there was an announcement that Powergen was investing overseas. In November 1996 the share price increased and it increased again in January 1997. In April 1998 the price rose to about £8.60 and then fell slightly. MAM sold the scheme's remaining Powergen shares in July 1998 when the price was about £7.70 per share.

The claim for the tax credits

40. The gross amount deemed to have been received by the Appellants by way of distribution from the first sale was £267,187.00 made up as follows:

Consideration received from the sale of the shares £236,250.00

Less capital originally subscribed £ 22,500.00

£213,750.00

Add tax credit £ 53,437.00

Total £267,187.00

41. The gross amount deemed to have been received by the Appellants by way of distribution from the second sale was £217,376.00 calculated as follows:

Consideration received from the sale of the shares £193,982.00

Less capital originally subscribed £ 20,081.00

£173,901.00

Add tax credit £ 43,475.00

Total £217,376.00

42. On 3 July 1996 a claim was submitted to the Inland Revenue on behalf of the Appellants for tax credits of £53,437 for the first sale and £43,475 for the second sale and the tax credits were paid to the Appellants on 12 August 1996. Together the two tax credits amount to £96,912 which is the amount of the assessment the subject of the appeal.

The section 703 notice

43. On 7 December 1998 the Inland Revenue served a notice on the Appellants under section 703(9) of the 1988 Act. The notice stated that the Board had reason to believe that section 703 applied to the transactions described in the schedule to the notice. The schedule referred to the sales of 16 May 1996 and 5 June 1996. On 21 December 1998 Mr Mullins swore a statutory declaration and on 30 December 1998 the Secretary of the Appellants swore a statutory declaration. The Inland Revenue sent both statutory declarations and a counter statement to the tribunal constituted under section 706 of the 1988 Act. On 10 November 1999 the tribunal determined that there was a prima facie case for proceeding in the matter.

The legislation relating to the tax credits received by the Appellants

44. Before considering the issues for determination in the appeal we find it convenient to set out the statutory provisions under which the Appellants became entitled to the tax credits as these provisions are relevant to the arguments raised by the parties.

45. Part VI (sections 207A to 255) of the 1988 Act contains provisions relating to company distributions, tax credits, etc. Section 209 defines the meaning of "distribution" and section 209(2)(b) includes within the definition:

"(b) ... any other distribution out of the assets of the company (whether in cash or otherwise) in respect of shares in the company, except so much of the distribution, if any, as represents repayment of capital on the shares or is, when it is made, equal in amount or value to any new consideration received by the company for the distribution."

46. It was agreed that it followed from section 209(2)(b) that the sale of shares to a company owning the shares was a distribution by the company to the extent that the proceeds of sale did not represent repayment of capital on the shares or to the extent that it exceeded the "new consideration" received by the company. Section 254 contains provisions relating to the interpretation of Part VI and the relevant parts of section 254 provide:

"254(1) In this Part, except where the context otherwise requires-

"new consideration" means, subject to subsections (5) and (6) below, consideration not provided directly or indirectly out of the assets of the company, and in particular does not include amounts retained by the company by way of capitalising a distribution; ...

(6) Subject to subsection (7) below, no consideration derived from the value of any share capital or security of a company, or from voting or other rights in a company, shall be regarded for the purposes of this Part as new consideration received by the company unless the consideration consists of: ...

(c) the giving up of the right to the share capital or security on its cancellation, extinguishment or acquisition by the company.

(7) No amount shall be regarded as new consideration by virtue of subsection (6)(b) or (c) above in so far as it exceeds any new consideration received by the company for the issue of the share capital or security in question or, in the case of share capital which constituted a qualifying distribution on issue, the nominal value of that share capital."

47. It was agreed that it followed from section 254(7) that "new consideration" was limited to the amount of the nominal value of the share capital.

48. Accordingly, it was agreed that it followed, from a combination of section 209 and section 254, that the sale of shares to a company owning the shares was a distribution by the company save to the extent that it related to the nominal value of the share capital which, in most cases, would be comparatively small. Accordingly, most of the purchase price received by Powergen from the Appellants was treated as a distribution to the Appellants.

49. At the time of the sales of the shares advance corporation tax was payable by Powergen in respect of the distributions. As a result of section 231(1) the Appellants were entitled to receive a tax credit equal to such proportion of the distribution as corresponded to the rate of advance corporation tax and as a result of section 231(3) to have the credit paid to them as it exceeded the income tax chargeable on their income. (No income tax was chargeable on the Appellants' income because of section 592(2)).

50. After 8 October 1996 the law was changed and Schedule 7 of the Finance Act 1997 provided a special treatment for certain distributions. As a result of those provisions an exempt approved fund could no longer claim a tax credit where it sold shares to the company owning those shares. Advance corporation tax was abolished by section 31 of the Finance Act 1998 after which no tax credits were claimable at all.

Reasons for decision

51. We now consider separately each of the issues for determination in the appeal.

Issue (1) – Did the scheme receive an abnormal amount?

52. The first issue is whether the circumstances were as mentioned in section 704A and, in particular, whether the Appellants received an abnormal amount

within the meaning of section 704A as clarified by sections 709(2), 709(4)(b) and 709(6)(b).

53. We first identify the questions we have to answer and we begin by considering section 709(2). That provides that "references to dividends include references to other qualifying distributions and interest". Section 709(2) does not say that qualifying distributions are deemed to be dividends; just that where there is a reference to dividends one should also insert a reference to qualifying distributions. Thus, although the arguments of the parties used the phrase "abnormal amount by way of dividend" we consider that, in the context of the present appeal, the more correct phrase is "abnormal amount by way of qualifying distribution".

54. The arguments of the parties on this issue raised two questions, namely:

(a) is the reference to a dividend (qualifying distribution) in section 709(4) a reference to the distribution only or to the aggregate of the distribution and any associated tax credit?; and

(b) in considering what is a normal return should regard be paid to the fact that on selling the shares the Appellants disposed of the whole of the capital value of their asset?

Question (a) - Is a distribution the aggregate of the distribution and the tax credit?

55. For the Appellants Mr Gardiner argued that, in considering whether an amount received by way of distribution should be treated as abnormal, regard should be had only to the amount of the distribution and not to the associated tax credit. He argued that Vinelott J had been wrong in Inland Revenue Commissioners v Universities Superannuation Scheme Limited [1997] STC 1 to accept that a dividend was the aggregate of the distribution and associated tax credit. Section 20(1)2 of the 1988 Act had a limited purpose and effect and did not apply to all references to distributions. If it did then section 14(1) would not make sense and section 231(1) would be otiose. He preferred the definitions in section 832(1) and section 209(2)(a) which defined a distribution as being the amount distributed.

56. For the Inland Revenue Mr Henderson argued that the amount received by the Appellants was both the distribution and the associated tax credit and he relied upon Universities Superannuation Scheme.

57. Universities Superannuation Scheme (1997) concerned an exempt approved scheme which participated in a share buy-back. In the High Court Vinelott J, at page 20f, held that in section 709(4) the reference to a "dividend" must be read as a reference to the aggregate of the distribution and any associated tax credit.

58. Although, therefore, we have some sympathy with the arguments of Mr Gardiner, we are bound by the decision in Universities Superannuation Scheme and accordingly conclude that the reference to a dividend (or distribution) in section 709(4) is a reference to the aggregate of the distribution and any associated tax credit.

Question (b) - Did the return exceed a normal return?

59. The second question arising out of this issue is whether, in considering what is a normal return, regard should be paid to the fact that on selling the shares the Appellants disposed of the whole of the capital value of their asset.

60. For the Appellants Mr Gardiner argued that the Appellants had disposed of the whole of the capital value of their investment and so the return they received was not abnormal. Section 709(4)(b) provided that, in considering what was a normal return, regard had to be paid to the consideration provided by the Appellants for the shares. The Appellants had paid the full market price for the shares. However, they were deemed to have sold them for their nominal value only and so the balance of the sale price was a normal return to compensate them for the loss of their capital asset. This interpretation would resolve the conundrum posed by having to apply the statutory provisions in section 703 to the different provisions of section 209. He cited Lomax v Peter Dixon [1942] 25 TC 353 at 363-5 as authority for the view that, in considering a normal return, it was necessary to consider the circumstances of the transaction or the terms of the security and each case had to be considered on its own facts. Good risks paid lower rates and higher risks paid higher rates. It was also necessary to look at the nature of the consideration given for the acquisition of the security. If a security provided a premium on redemption then the interest rate would be lower. If it provided for a discount on redemption then the interest return would be higher. If on redemption no principal was to be repaid the normal return would have to compensate the investor for the loss of his capital. He also cited Cedar v Inspector of Taxes [1998] STC (SCD) 78 at 91g. Finally, he argued that Vinelott J in Universities Superannuation Scheme appeared not to dispute that the risk profile of an investment was a relevant factor.

61. For the Inland Revenue Mr Henderson argued that the effect of section 209(2)(b) was to turn into income what would otherwise have been capital payments made to the Appellants as consideration for their shares. Without section 209(2)(b) there would be no tax credit and, as the Appellants had claimed the tax credit, they could not argue at the same time that the amount was not income. As a result of section 209 about 95% of the price which the Appellants had received from Powergen for the sale of the shares was income. He argued that the factors to be considered in determining a normal return were the risk of the investment and the length of time the investment was held. The Powergen shares were not a risky investment and had been held for three months (from February to May). For those shares for that length of time 95% was an abnormal return. Mr Henderson accepted that, if he were right, then most buy-backs would give an abnormal return but he argued that that arose from the statutory provisions and that, in any event, the statutory defence in section 703 was always open to taxpayers. He argued that the words of Lord Greene in Lomax were not relevant to an interpretation of section 704 and instead he relied upon the words of Vinelott J in Universities Superannuation Scheme at page 21b. However, he distinguished that case on its facts as there the shares had two elements, namely cash together with an agreement to accept a lower rate of interest, and the valuation of the second element was an issue in that appeal. The Powergen shares had no special terms.

62. Before considering the arguments of the parties we first recall the relevant facts. On the first buy-back 45,000 shares were sold for £5.25 per share making a total sale price of £236,250.00. Here we assume, on the basis of first in first out, that the shares sold into the buy-back were those purchased on 26 February 1996 for £5.39 per share. Accordingly, the shares sold on the first buy-back cost the Appellants £242,550.00 and that was the consideration provided by the Appellants within the meaning of section 709(4)(b). That means that the shares

were sold at a loss by the Appellants and they lost capital of £6,300.00. However, by virtue of the statutory provisions, Powergen were treated as paying a return of capital of £22,500.00 (which represents a loss to the Appellants of capital of £220,050.00 as compared with the purchase price of £242,550.00) and a distribution of £213,750.00 which carried a tax credit of £53,437.00. The receipt of the tax credit by the Appellants turned their deficit of £6,300.00 into a credit balance of £47,137.00.

63. On the second buy-back 40,162 shares were sold for £4.83 per share making a total sale price of £193,982.00. Again we assume, on the basis of first in first out, that the shares sold were those purchased on 26 February 1996 for £5.39 per share so the shares sold on the second buy-back cost the Appellants £216,473.18. Thus those shares were also sold at a loss to the Appellants who lost capital of £22,491.18. However, by virtue of the statutory provisions, Powergen were treated as paying a return of capital of £20,081 (which represents a loss to the Appellants of capital of £196,392.18 as compared with the purchase price of £216,473.18) and a distribution of £173,901.00 which carried a tax credit of £43,475.00. The receipt of the tax credit by the Appellants turned their deficit of £22,491.18 into a credit balance of £20,983.82.

64. With those facts in mind we now consider the statutory provisions. Here we are faced with two distinct sets of tax provisions (namely those dealing with tax avoidance on the one hand and those dealing with the taxation of companies on the other) together with a third set of provisions in company legislation. The two sets of tax provisions have developed at different times along different routes.

65. The tax avoidance provisions were first enacted in 1960 and the provisions which are now in section 704A were first found in section 28(2)(b) of the Finance Act 1960. Although certain technical amendments were made by paragraph 2 of Schedule 11 of the Finance Act 1973, the reference to an "abnormal amount by way of dividend" has survived in the tax avoidance provisions since 1960.

66. The company taxation provisions were first enacted in 1965. The definition of a "distribution" which is now in section 209(2)(b) of the 1988 Act is in the same terms as section 233(2)(b) of the Income and Corporation Taxes Act 1970 and that was first enacted as paragraph 1(1)(b) of Schedule 11 of the Finance Act 1965.

67. In 1973 the two sets of provisions were bridged by the enactment of section 25 and Schedule 11 of the Finance Act 1973. Paragraph 5(1) of Schedule 11 first provided that, in the tax avoidance provisions, "references to dividends include references to other qualifying distributions". At that time it was not possible for a company to purchase its own shares and so, when the statutory provisions with which we are concerned were first enacted, the facts of the present appeal could not have been in the mind of Parliament.

68. In 1981 it became possible for a company to purchase its own shares. Section 46 of the Companies Act 1981 first provided that, in certain circumstances, a company might purchase its own shares. Section 46 was subsequently re-enacted as section 162 of the Companies Act 1985. In the company tax legislation, the meaning of "distribution", first enacted in 1965 when a company could not purchase its own shares, is wide enough to cover the case where a company does purchase its own shares.

69. In most cases payment for the purchase of its own shares by a company is made from distributable profits. In other words, the payment by the company is a

payment from income and this is recognised by the tax legislation applicable to companies which treats the payment as a distribution (save for the repayment of the amount of the nominal capital of the shares).

70. This appeal is unusual because it is necessary to apply tax avoidance provisions which were enacted at a time when the facts of this appeal could not have been foreseen. We have found it helpful to keep separate the corporation tax provisions on the one hand and the tax avoidance provisions on the other. The corporation tax provisions apply to Powergen and describe the nature of the money paid by Powergen, namely as mostly qualifying distribution with a small return of nominal capital. On the other hand we have to interpret the tax avoidance provisions as they apply to the Appellants. Here it is relevant that, when the Appellants sold the shares, they were disposing of a capital asset. It was an asset which had been purchased at a market price and at arm's length and which was sold in the same way. Mr Henderson argued that, as a result of section 209, most of what the Appellants received from Powergen was income. But section 209 does not say that. What is says is that what most of what Powergen paid was income; that does not mean that it has to be income in the hands of the recipient.

71. With that general statutory background in mind we now turn to consider specifically the tax avoidance provisions. What we first have to decide is whether the Appellants received "an abnormal amount by way of qualifying distribution" within the meaning of section 704A. Section 709(4)(b) guides us in reaching this decision as it tells us specifically that what we have to decide is whether the amount received by the Appellants by way of qualifying distribution "substantially exceeds a normal return on the consideration provided by" the Appellants for the Powergen shares. Section 709(6)(b) provides yet further guidance as it tells us that, in determining what is a normal return, we must have regard to the length of time that the Appellant held the shares before receiving the qualifying distribution.

72. We therefore start with section 704A and ask whether the person in question received an abnormal amount by way of qualifying distribution. In our view the words "the person in question" make it quite clear that we have to look at the position of the Appellants and ask whether, from the Appellants' point of view, they received an abnormal amount by way of qualifying distribution. We do not have to ask whether Powergen paid an abnormal amount.

73. The purchases by the Appellant were on the open market and at open market prices; the sales were at prices fixed by Powergen but the shares were offered by Powergen to the market at prices which were close to the prevailing prices at the relevant times. In order to attract sellers Powergen would have had to fix the offer price at a price which was sufficiently close to the market price (otherwise sellers would have sold on the market). It was a feature of the corporation tax legislation (namely the legislation applying to Powergen) that the price paid by Powergen was made up of two elements. One element was of capital equal to the amount of the nominal capital value of the shares; the remainder was the qualifying distribution. The nominal value of the shares was fixed and so the qualifying distribution had to be of such amount as would make the total price attractive to sellers who were disposing of their assets and who had the alternative of selling on the market. As the amount of the qualifying distribution was thus, in effect, fixed by the market it was, in our view, normal. Bearing in mind the facts of the present appeal, we would conclude that the person in question (namely the Appellants) did not receive an abnormal amount by way of qualifying distribution. The amount they received was normal for what they sold.

74. We pass on to section 709(4)(b) and here we have to decide if the amount received by way of qualifying distribution substantially exceeded a normal return on the consideration provided by the Appellants for the shares. We first note that the words are "normal return" and not "normal income" or "normal income yield". That indicates to us that "return" is a wider phrase than a return of income. Here the facts are that, on the first buy-back the Appellants bought shares for £242,550 and sold them for £236,250. As we have already decided that the amount of the qualifying distribution has to include the tax credit, that means that the amount received by the Appellants was increased by £53,437 making a total of £289,687, a gain on the transaction of £47,137 or 19%. On the second buy-back the Appellant bought shares for £216,473.18 and sold them for £193,982 plus the tax credit of £43,475 making a total of £237,457, a gain on the transaction of £20,983.82 or 9.69%. Here it is relevant that the market price of the shares rose to about £8.60 in April 1998 an increase of 59% on the price of the first buy-back and of 78% on the price of the second buy-back. Thus we would conclude that the amount received by the Appellants could be regarded as a normal return.

75. Also, the "normal return" must be "on the consideration provided by the recipient for the securities". This is a somewhat unexpected provision. In the context of tax avoidance one would expect a comparison to be made between capital paid to a company for securities and income received from the company in respect of those securities. However, in this appeal the consideration paid by the Appellants was paid to a seller on the open market, and not to the company. Also, the decision by Powergen to buy back its shares was not made in conjunction with the Appellants. The consideration provided by the Appellants for the shares was the sum of £5.39 per share. The amount received by the Appellants for those shares was £5.25 and £4.83 respectively with the addition of the tax credit in each case. Thus what the Appellants received was a normal return on the consideration which they provided for the securities.

76. Finally, under section 709(6)(b) we have to have regard to the length of time during which the Appellants held the shares. This was three months for the shares sold in the first buy-back and four months for the shares sold in the second buy-back. Here it is also relevant that the market price of the shares rose to about £8.60 in April 1998 an increase of 59% or 78%. Thus, having regard to the length of time for which the shares were held, the return did not substantially exceed a normal return.

77. Bearing in mind that the Appellants were disposing of a capital asset we are of the view that the amount received by the Appellants by way of qualifying distribution did not substantially exceed a normal return on the consideration provided by the Appellants for the shares having regard to the length of time for which the shares were held.

78. Having reached that view on the statutory provisions we now turn to consider the authorities cited to us to see what principles they establish.

79. In Lomax (1943) a loan of £319,000 was made repayable on demand. Later an agreement was entered into whereby the debtor issued to the creditor 680 loan notes of £500 each, amounting in total to £340,000 (a discount of 6%). The notes were to bear interest at a rate of about 5 per cent. 100 were to be repaid almost immediately and the rest over a period of 20 years. Each note was to be redeemed at a premium of 20% if the debtor's profits reached a specified level. The issue was whether the discount and premium were capital or income for income tax purposes. At page 363 Lord Greene, MR indicated that each case had

to be considered on its own facts. He discussed the ordinary issue of debentures by a limited company. If the credit of the company was good and the security ample then the issue could be at par at a reasonable rate of interest. If the credit and the security were exceptionally good then the issue could be made at a premium, which would be capital because the subscriber would be getting a good security. Alternatively such a company could issue its debentures at par with a lower rate of interest. If the credit or security were not good then the company could issue the debentures at par but with a high rate of interest, or issue them at a discount with a normal rate of interest, or issue them at par with a premium on redemption. However, the premium on redemption and the premium on issue were the expression of the risk in terms of capital rather than in the terms of interest. Whether income tax was payable depended on the method chosen by the company. The discount and premium in that appeal were capital.

80. Thus Lord Greene MR was discussing the issue of debentures rather than the receipt of dividends or qualifying distributions. Although that decision is authority for the view that, as far as debentures are concerned, the principle is that regard must be had to the risk of the investment and the underlying security offered, that principle is not directly relevant in the present appeal where we have to apply the language of the tax avoidance provisions. However, it does support the argument of Mr Gardiner that, in considering a normal return, regard should be paid to all the relevant factors.

81. Universities Superannuation Scheme (1997) concerned an exempt approved scheme which participated in a share buy-back. The scheme agreed to lend money to finance the development of a business park on certain conditions. One of the conditions was that the scheme would have the right to purchase shares in the developer with a put option entitling the holder of the shares to require that they be bought back at a percentage of the net asset valuation of the developer in the business park. Because of the put option the rate of interest on the loan was less than a commercial rate. The scheme purchased the shares for £100,000. Four years later the put option was exercised and the buy back gave rise to a distribution of £2,562,750 by the developer to the scheme which claimed a tax credit of £854,250. The Special Commissioner treated the sum of £2,562,750 as the amount of the distribution and held that, on the facts, the distribution was not of an abnormal amount as it was also necessary to take into account the fact that the scheme had agreed to accept a lower rate of interest on the loan and that the investment was speculative and would normally attract a higher rate of return. In the High Court Vinelott J at page 20a and g effectively agreed that it was necessary to consider all the relevant factors (including the benefit of the obligation of the scheme to make the loan at a low rate of interest) and not only the price actually paid for the acquisition of the shares. He remitted the matter for a decision on the facts to another tribunal. The difference between a purchase price of £100,000 and a sale price even of £2,562,750 is far in excess of the differential in the present appeal. Accordingly, we do not find that authority of great assistance.

82. We have reached our decision on the words of the statutory provisions. We conclude that the circumstances were not as mentioned in section 704A and that the Appellants did not receive an abnormal amount by way of qualifying distribution and that the amount of the qualifying distribution did not exceed a normal return on the consideration provided by the Appellants for the shares having regard to the length of time that the Appellants held those shares.

83. That means that section 703 does not apply to the Appellants and the appeal must be allowed. We do not need to consider the other issues in the appeal. However, as arguments were put to us we express our views.

Issue (2) – Did the scheme obtain a tax advantage?

84. The second issue in the appeal is whether the Appellants obtained a tax advantage within the meaning of section 709(1) which provides as follows:

"709(1) In this chapter "tax advantage" means a relief or increased relief from, or repayment or increased repayment of, tax, or the avoidance or reduction of a charge to tax or an assessment to tax or the avoidance of a possible assessment thereto, whether the avoidance or reduction is affected by receipts accruing in such a way that the recipient does not bear tax on them, or by a deduction in computing profits or gains."

85. For the Appellants Mr Gardiner argued that section 709(1) defined a tax advantage to include a relief from tax but did not mention an exemption from tax. Parliament used the word "exemption" to remove income from the charge to tax and used the word "relief" where taxable income had been received and the tax payable was to be reduced. In support of his argument he analysed a number of the provisions of the 1988 Act which gave exemptions and reliefs and placed these within the context of the history and purpose of section 703. He argued that the purpose of section 703, when it had been introduced as section 28 of the Finance Act 1960, had been to combat "dividend stripping"; the section had been aimed at loss relief and repayments and not at dividend income. When the imputation system of corporation tax was introduced in 1972, and deduction at source and repayments ceased, section 703 had been amended but there had been no change in the definition of "tax advantage". For these reasons the section included references to reliefs and repayments but not to exemptions and it would be an abuse of language to describe the receipt of income, which Parliament had provided should be exempt, as a tax advantage. He relied upon Sheppard and another (Trustees of the Woodlands Trust) v Inland Revenue Commissioners (No 2) [1993] STC 240 at 254c-j. He accepted that the decision in Universities Superannuation Scheme was contradictory but argued that Sheppard was conceptually correct.

86. For the Inland Revenue Mr Henderson argued that the decision in Universities Superannuation Scheme was later than the decision in Sheppard and so should be followed and he relied upon Colchester Estates v Carlton Plc [1986] Ch 80 at 84E – 86C. In any event he argued that the decision in Universities Superannuation Scheme was correct. Although he accepted that the words "relief" and "repayment" were originally included in section 703 with dividend stripping in mind, he argued that the section was not confined to that mischief. The 1988 Act had been enacted after the introduction of the imputation system in 1972 and all consolidation Acts had to be approached on their own terms. The section had therefore to be interpreted in the context of the imputation system. Neither the word "exemption" nor the word "relief" were terms of art and he argued that "relief" was wide and that "exemption" was a sub-set of a relief.

87. In considering the arguments of the parties we first refer to Colchester Estates. The principle enunciated by Nourse J at page 85C-H is that, where there are conflicting decisions of courts of co-ordinate jurisdiction, the later decision is to be preferred, if it is reached after full consideration of the earlier decision, except in the rare case where the third judge is convinced that the second was

wrong, for example because some binding or persuasive authority was not cited. With that principle in mind we consider the other authorities cited by the parties.

88. In Sheppard (1993) shareholders in a company, who were also trustees of a registered charity, renounced bonus shares, and waived their right to a dividend, in favour of the charity, after which the company declared a dividend and paid it to the charity who claimed the tax credit in respect of the dividend. At page 254c Aldous J concluded that the words "relief" and "exemption" had distinct meanings. "Relief" normally indicated the alleviation of an obligation and "exemption" denoted the removal of an obligation. A person who obtained a relief from tax obtained a tax advantage but a person who had no obligation to pay tax did not obtain a tax advantage by taking steps which resulted in his paying no tax. He referred to the words of Lord Wilberforce in IRC v Parker [1966] AC 141 at 178-179 where Lord Wilberforce distinguished the situation where receipts could have accrued in a taxable way (where there could be a tax advantage) from the situation where receipts could not have accrued in a taxable way (where there could be no tax advantage). He concluded that, as the trustees were exempt from paying tax, they did not claim a relief in the sense that that word was used in what was then section 466 (now section 709(1)).

89. In Universities Superannuation Scheme (1996) Vinelott J, at pages 17 to 19, outlined the history of corporation tax and the history of the predecessors of section 703. He referred to the words of Lord Wilberforce in Parker and held that the distinction between the situation where receipts could have accrued in a taxable way from the situation where receipts could not have accrued in a taxable way was only relevant when the advantage was sought by way of the avoidance or reduction of an assessment. He held that the exemption of the income of an exempt body is a "relief" from tax within the definition of a "tax advantage".

90. Following the principle in Colchester, as there are conflicting decisions of courts of co-ordinate jurisdiction, we must prefer the later decision. It was reached after full consideration of the earlier decision (at pages 14 to 16) and no binding or persuasive authority was cited to us which would lead us to conclude that the decision is wrong.

91. Accordingly, we conclude that the Appellants did obtain a tax advantage within the meaning of section 709(1).

Issue (3) – Were the sales made for bona fide commercial reasons or in the ordinary course of making or managing investments?

92. The third issue in the appeal is whether the sales were carried out for bona fide commercial reasons or in the ordinary course of making or managing investments within the meaning of section 703(1).

93. The arguments of the parties on this issue raised two questions, namely:

(a) Were the shares sold in the ordinary course of making or managing investments ?; and, if not

a. Were the shares sold for bona fide commercial reasons?

Question (a) – Making or managing investments

94. For the Appellants Mr Gardiner argued that the shares were both bought and sold in the ordinary course of making and managing investments. The Appellants had an investment business which was managed for them by MAM. The shares were acquired for good investment reasons and sold when those reasons disappeared. The shares were purchased on the open market and sold pursuant to an unsolicited offer from Powergen. If Mr Mullins had decided not to sell he would have been in breach of the best execution rule.

95. For the Inland Revenue Mr Henderson accepted that the shares were sold in the managing of investments but argued that that did not necessarily mean that they were sold "in the ordinary course" of managing investments. He cited the decision of the Special Commissioner in Universities Superannuation Scheme 70 TC at 203 F-G and distinguished the decision in Lewis v Inland Revenue Commissioners [1999] STC (SCD) 349.

96. In Universities Supernnuation Scheme at page 203 F–G the Special Commissioner expressed the view that, on the facts of that appeal, the abandonment of the put option and the sale of the shares to the company with the claim for a tax credit was not "ordinary". No view was expressed on this finding by Sir John Vinelott in the High Court. The facts in Universities Superannuation Scheme were different from the facts in the present appeal. Here there was no separate agreement between the Appellants and Powergen. Indeed, the Appellants and Powergen had no agreement at all.

97. Lewis also concerned trustees who participated in a buy-back .On the facts of that appeal the Special Commissioners held (at page 362e) that the trustees reacted to a special set of circumstances in a special way by taking the simplest and cheapest option open to them and doing what any prudent investor would do in the circumstances. In doing so they were acting in the ordinary course of managing investments.

98. On the facts of the present appeal we find that the Appellants did what any prudent investor would do in the circumstances and that they were acting in the ordinary course of managing investments. Although the Appellants were under no obligation in May and June 1996 to sell the Powergen shares there were good investment reasons for such sale. The original investment rationale had been the expected enhancement of value by the vertical integration in the power industry with the acquisition of Midlands. When it became clear that that was not to proceed, the sales of the shares into the buy-backs became a prudent option. We also find the following factors relevant, namely: that MAM's only function was to manage investments; that what they did was, for them, "ordinary", namely they sold shares which was what they were doing all the time; that what they did for the Appellants was what they did for other clients; that there was no connection at all between the Appellants and Powergen; that the Appellants did what every other holder of shares was entitled to do; and that participation in share buy-backs was a normal thing. There is nothing out of the ordinary in selling shares into buy-backs when the parties are at arm's length.

99. We therefore conclude that the Appellants were acting in the ordinary course of managing investments. That conclusion means that we do not have to consider the second question on this issue but as arguments were put to us we briefly express our views.

Question (b) – Bona fide commercial reasons

100. For the Appellants Mr Gardiner argued that the shares were sold for bona fide commercial reasons. He referred to section 130 of the 1988 Act and argued that the trustees had an investment business. He relied upon Lewis at p362 paragraphs 19 and 20. He distinguished Inland Revenue Commissioners v Goodwin [1976] STC 28 where the taxpayers were individual shareholders unlike the Appellants who were the trustees of a pension fund. He also cited Clark v Commissioners of Inland Revenue (1978) 52 TC 482 at page 495 g; Rolls v Miller (1884) 27 Ch.D 71; Town Investments Limited v Department of the Environment [1976] 1 WLR 1126; and The Commissioners of Inland Revenue v The Korean Syndicate Ltd (1921) 12 TC 181.

101. For the Inland Revenue Mr Henderson accepted that the managing of investments could be a business but argued that a transaction was carried out for commercial reasons only if it was carried out with the subjective aim of protecting or enhancing the prosperity of a trade or business. He argued that the trustees of a pension scheme were not in business of a commercial nature and they did not conduct a commercial activity. He relied upon Goodwin at pages 34 – 35; 614I – 615B; Clark at 492G-h and 494B and Marwood Homes Limited v Inland Revenue Commissioners [1999] STC (SCD) 50h and 62 e-f. He distinguished Lewis where there was a business.

102. Of all the authorities cited to us we have found Lewis (1999) to be most relevant as that also concerned trustees who participated in a buy-back. There the Special Commissioners left open the question as to whether a reason for an investment decision could be a commercial reason. We note that section 703 provides that the ordinary course of managing investments is an alternative to bona fide commercial reasons and that might point to the conclusion that the statutory provisions assume that if one of the alternatives applies the other might not. Like the Special Commissioners in Lewis, we do not have to decide this question and so leave it open.

Issue (4)- Was a main object of the sales to enable tax advantages to be gained?

103. The fourth issue in the appeal is whether the sales had as their main object, or one of their main objects, to enable tax advantages to be obtained within the meaning of section 703(1).

104. The arguments of the parties on this issue raised two questions, namely:

(a) whether, if the Appellants established that the transactions were carried out either for bona fide commercial reasons or in the ordinary course of managing investments (or both) it necessarily followed that it was not a main object to enable tax advantages to be obtained; and

(b) whether the Appellants had as a main object to enable tax advantages to be obtained.

(a) Does it necessarily follow that tax advantages were not a main object?

105. For the Appellants Mr Gardiner argued that, if a transaction were carried out for bona fide commercial reasons or in the ordinary course of making or managing investments, that would preclude the conclusion that a main object was to enable a tax advantage to be claimed. For the Inland Revenue Mr Henderson argued that it did not necessarily follow that, if the Appellants established either that they were acting in the ordinary course of managing

investments or for bona fide commercial reasons, then a main object was not to obtain tax advantages. He cited Goodwin at 607G and Marwood Homes at 50b.

106. We start with the words of section 703(1). That provides that a taxpayer has to show the presence of two elements, namely both that the transactions were carried out for bona fide commercial reasons (or in the ordinary course of managing investments) and that a main object was not to enable tax advantages to be gained. That indicates to us that it was the intention of Parliament that both elements had to be proved separately. If Mr Gardiner were right in saying that if the first element applied then it followed that the second also applied, the second element would be otiose. Mr Gardiner cited no authority for his view. In Goodwin Russell LJ at page 607G stated that, as one would expect, there can be a bona fide commercial transaction with the obtaining of a tax advantage as a main object. In Marwood Homes the Presiding Special Commissioner, as Chairman of the Tribunal constituted under section 706, said at page 50h that "if a taxpayer succeeds on the first limb he will not necessarily succeed on the second limb".

107. Accordingly we conclude that, even though the Appellants have established that the transactions were carried out in the ordinary course of managing investments, it does not necessarily follow that neither of them had as their main object to enable tax advantages to be obtained.

(b) Was a main object to enable tax advantages to be obtained?

108. For the Appellant Mr Gardiner argued that the fiscal consequences of the transactions were those prescribed by Parliament. The test was set out in Inland Revenue Commissioners v Brebner 43 TC 705 at 713D. He also relied upon the words of Cross J in Inland Revenue Commissioners v Kleinwort Benson Limited (1968) 45 TC 369 and argued that, even if the shares had been purchased in expectation of the buy-back giving rise to the tax credit, that would still be the ordinary statutory consequences of an ordinary transaction. Tax relief was given to the scheme by section 592(2) and the scheme claimed the tax credit under those provisions. Other reliefs also were claimed under the provisions of the legislation (for example retirement annuity relief). It was an abuse of language and ridiculous to say that statutory consequences constituted the object of the person entering into the transaction. It could not be an object to get tax advantages by entering into a simple transaction with ordinary fiscal consequences prescribed by Parliament. There was nothing contrived and nothing artificial and so there was no tax avoidance. It was not open to the Inland Revenue to defeat the intentions of Parliament as expressed in section 592(2) by applying section 703. He relied upon the fact that, on the occasions of both sales, MAM had not participated in the buy-backs just to obtain the tax credits and then gone back into the market to re-purchase the shares. The shares had been sold because the reasons why they had been acquired had vanished and MAM wanted to dispose of them and to reduce its holdings in utilities in accordance with its investment strategy.

109. For the Inland Revenue Mr Henderson argued that the question whether a main object had been to enable tax advantages to be obtained had to be considered as a subjective matter of intention and had to be ascertained by looking at the transaction as a whole with broad common sense. He cited Brebner at 714-715. He accepted that a business man would always choose the most tax-efficient way of carrying out a genuine commercial transaction but, if the method fell within section 703, then he also had to show that obtaining a tax advantage was not a main object. The fact that a transaction was carried out to achieve a benefit conferred by a statutory provision would not of itself preclude the

application of section 703 and he relied upon Marwood Homes at 50b. He distinguished Kleinwort Benson on its facts and also because the words of Cross J relied upon by the Appellants were not part of the reasons for the decision.

110. Before considering the general principle we record that we agree with Mr Henderson that the fact that a transaction was carried out to achieve a benefit conferred by a statutory provision would not of itself preclude the application of section 703. In Marwood Homes the Presiding Special Commissioner (as Chairman of the Tribunal constituted under section 706) said at page 50b that the fact that a transaction had been carried out to achieve a benefit conferred by a statutory provision would not of itself exclude the application of section 703.

111. The general principle we should apply was established in Brebner where Lord Upjohn said at 2 AC 18 at page 30:

"I agree that the question whether one of the main objects is to obtain a tax advantage is subjective and … is essentially a task for the Special Commissioners".

112. Later he said at 30:

"My Lords, I would conclude my speech by saying, when the question of carrying out a genuine commercial transaction, as this was, is reviewed, the fact that there are two ways of carrying it out – one by paying the maximum amount of tax, the other by paying no, or much less, tax - it would be quite wrong as a necessary consequence, to draw the inference that, in adopting the latter course, one of the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out a commercial transaction except on the footing of paying the smallest amount of tax that he can. The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners to decide upon a consideration of all the relevant evidence before them and the proper inferences to be drawn from that evidence."

113. Applying those principles to the facts of the present appeal we ask what was the subjective intention in the mind of Mr Mullins when he decided to participate in the buy-backs?

114. We have found as facts that Mr Mullins purchased the Powergen shares because, after the announcement of the bid, he liked Powergen. The bid offered the prospect of vertical integration in the power market, with electricity generation and distribution combined in one company. If the bid were successful, Powergen's earnings would be substantially enhanced and that this would be reflected in the price of its shares. Accordingly, a holding of such shares would out-perform the Index and the targets would be met. We have accepted the evidence of Mr Mullins that he would never buy a share just in order to participate in a buy-back because it was never possible to sell all one's holding into a buy-back; buy-backs were always limited to a percentage of the shares and were heavily over-subscribed. We have also accepted the evidence of Mr Mullins that generally he only bought for long-term growth and did not like excessive activity. The shares were purchased for the scheme because he was of the view that they would be a good investment for the scheme; the buy-back was not the primary reason for the purchase.

115. However, it is not the purchases which are the subject of the notice under appeal but the two sales of 16 May 1996 and 5 June 1996. Here we are of the view that the sales were made when they were made only because Mr Mullins

knew that he would receive the tax credits. When the buy-backs were announced, Mr Mullins appreciated that the purchase price announced by Powergen together with the associated tax credit provided an opportunity to achieve a sale of the shares held for the scheme at a price which was considerably in excess of his targets. The tax credits were crucial. A sale of the shares on the market at the prevailing price would have resulted in a deficit. It was the tax credits which made the difference between a sale which resulted in a deficit and a sale which resulted in a credit balance. It is also relevant that Mr Mullins' strategy was to hold shares for the medium to long term and, in the event, the shares which could not be sold into the buy-backs were not sold on the market immediately but were held until July 1998 and then sold for a price considerably in excess of the price obtained in the buy-backs. Finally, we note that all, or virtually all, of MAM's disposals into the buy-backs were made for gross funds and that also points to the conclusion that the obtaining of tax credits was a main object of participating in the buy-backs.

116. We accept that Mr Mullins had other objects in participating in the buy-backs. He wanted to dispose of the shares as the abandonment by Powergen of the bid for Midlands rendered it a less attractive investment. Also, the size of the holding held by MAM for all its clients meant that it was not possible to sell the shares immediately on the market without influencing the market price. The buy-backs offered opportunities for disposing of shares at a price fixed by Powergen. Again, Mr Mullins was obliged under the best execution rule to get the best price for his clients; he wanted to sell the shares for good investment reasons and considered that the buy-back was a good opportunity to do that. However, we remain of the view that the tax credits were crucial to Mr Mullins' decisions to sell into the buy-backs and so one of the main objects of the sales was to enable tax advantages to be obtained.

117. Mr Gardiner relied on Kleinwort Benson as authority for the view that where there was a single indivisible transaction, which was an ordinary commercial transaction (or which was in the ordinary course of managing investments), the fact that a particular taxpayer could recover tax under the statutory provisions applying to him, did not mean that a main object of the transaction was to obtain a tax advantage. However, the remarks of Cross J at page 382E, upon which Mr Gardiner relied, were not part of the reasons for his decision. And we have reached our views on the facts and evidence in this appeal.

118. We conclude that the sales did have as one of their main objects to enable tax advantages to be obtained within the meaning of section 703(1).

Decision

119. Our decisions on the issues for determination in the appeal are:

(1) that section 703(1)(a) does not apply because the circumstances were not as mentioned in section 704 and, in particular, that the Appellants did not receive an abnormal amount by way of qualifying distribution within the meaning of section 704A as clarified by section 709(4)(b) and section 709(6)(b); that means that we do not have to decide the other issues in the appeal but as arguments were put to us we express our views which are:

(2) that the Appellants did obtain a tax advantage as defined in section 709(1);

(3) that the sales were carried out in the ordinary course of managing investments within the meaning of section 703(1); and

(4) that the sales had as one of their main objects to enable tax advantages to be obtained within the meaning of section 703(1).

120. The appeal is, therefore, allowed.

121. 705(4) provides that the Special Commissioners have power to cancel or vary a notice under section 703(3) or to vary or quash an assessment made in accordance with such a notice.

122. We therefore cancel the notice under appeal and quash the assessment under appeal.

DR NUALA BRICE

MALACHY CORNWELL-KELLY

SPECIAL COMMISSIONERS

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