Financial futures transactions - Whether the "lending of money" - Whether "money debt" or "advance" granted - Whether Ramsey approach applicable - Relevant Revenue guidance as an aid to construction - FA 1996 s.80-103 - Whether capital gain - TA 1988 s.128 - CGTA 1992 s.143

THE SPECIAL COMMISSIONERS SpC 00295

HSBC LIFE (UK) LIMITED Appellant

and

K STUBBS

(HM INSPECTOR OF TAXES) Respondent

NATIONWIDE LIFE LIMITED Appellant

and

J P CRISP

(HM INSPECTOR OF TAXES) Respondent

ABBEY LIFE ASSURANCE CO LIMITED Appellant

and

H COLCLOUGH

(HM INSPECTOR OF TAXES) Respondent

T S B LIFE LIMITED Appellant

and

H COLCLOUGH

(HM INSPECTOR OF TAXES) Respondent

LLOYDS TSB LIFE ASSURANCE CO LTD Appellant

and

H COLCLOUGH

(HM INSPECTOR OF TAXES) Respondent

Special Commissioners: MALACHY CORNWELL-KELLY THEODORE WALLACE

Sitting in Private in London on 11, 12, 13, 14, 15, 18,

19, 21, 22 June 2001

Graham Aaronson QC, Terence Mowschenson QC and Camilla Bingham, for the Appellants

Launcelot Henderson, QC, Christopher Tidmarsh and David Rees, instructed by the Solicitor of Inland Revenue, for the Respondents

DECISION

Introduction

1. These appeals, which involve five taxpayer companies, concern issues which, we were told, affect a considerable number more. In formal terms, the appeals are against assessments to corporation tax for accounting periods starting with the year ending on 31st December 1996 to that ending on 31st March 1999. They arise from contracts by life insurance companies with derivatives dealers to cover the risk element in index-linked bonds issued by the life companies.

2. The issues in the appeals turn on the proper construction of provisions in the Finance Act 1996 introducing a new basis for the taxation of profits or losses arising from what the Act terms "loan relationships". No point arises on the transitional provisions introducing that regime. The essential question raised is whether receipts from the various transactions which we describe below, which are the making of contracts for financial futures, are subject to the loan relationship regime, and are consequently brought into account as income charged to corporation tax under Case III of Schedule D, or whether they are only taxed on the I-E basis according to capital gains tax rules when realised.

3. It is common ground that tax considerations played a decisive part in the choice of structures by the taxpayers, who stated openly that they had consciously sought to avoid their transactions falling within the loan relationship regime. It is also common ground that the transactions were genuine transactions and not shams, but the Crown allege that the deliberately tax-efficient structuring of the business affects the commercial and legal characterisation of what was done.

4. Fifty three representative transactions were initially in evidence but we were, in the event, invited to make our

decision by reference to six of these, with the caveat that findings of fact would be needed for all the representative transactions which do not provide for settlement by cash, or by cash with an option to take shares. We have proceeded on that basis.

The legislation

5. The principal legislation relevant to these appeals is contained in Chapter II of Part IV of the 1996 Act, and in Schedule 9 to the Act. The relevant provisions of the 1996 Act are as follows.

"80 Taxation of loan relationships

(1) For the purposes of corporation tax all profits and gains arising to a company from its loan relationships shall be chargeable to tax as income in accordance with this Chapter.

(2) To the extent that a company is a party to a loan relationship for the purposes of a trade carried on by the company, profits and gains arising from the relationship shall be brought into account in computing the profits and gains of the trade.

(3) Profits and gains arising from a loan relationship of a company that are not brought into account under subsection (2) above shall be brought into account as profits and gains chargeable to tax under case III of Schedule D.

(4) ...

(5) Subject to any express provision to the contrary, the amounts which in the case of any company are brought into account in accordance with this Chapter as respects any matter shall be the only amounts brought into account for the purposes of corporation tax as respects that matter.

81 Meaning of 'loan relationship' etc

(1) Subject to the following provisions of this section, a company has a loan relationship for the purposes of the Corporation Tax Acts wherever -

(a) the company stands (whether by reference to a security or otherwise) in the position of a creditor or debtor as respects any money debt; and

(b) that debt is one arising from a transaction for the lending of money;

and references to a loan relationship and to a company's being a party to a loan relationship shall be construed accordingly.

(2) For the purposes of this Chapter a money debt is a debt which falls to be settled -

(a) by the payment of money; or

(b) by the transfer of a right to settlement under a debt which is itself a money debt.

(3) Subject to subsection (4) below, where an instrument is issued by any person for the purpose of representing security for, or the rights of a creditor in respect of, any money debt, then (whatever the circumstances of the issue of the instrument) that debt shall be taken for the purposes of this Chapter to be a debt arising from a transaction for the lending of money.

(4) For the purposes of this Chapter a debt shall not be taken to arise from a transaction for the lending of money to the extent that it is a debt arising from rights conferred by shares in a company.

(5) For the purposes of this Chapter -

(a) references to payments or interest under a loan relationship are references to payments or interest made or payable in pursuance of any of the rights or liabilities under that relationship; and

(b) references to rights or liabilities under a loan relationship are references to any of the rights or liabilities under the agreement or arrangements by virtue of which that relationship subsists;

and those rights or liabilities shall be taken to include the rights or liabilities attached to any security which, being a security issued in relation to the money debt in question, is a security representing that relationship.

(6) In this Chapter 'money' includes money expressed in a currency other than sterling.

82 Method of bringing amounts into account

(1) For the purposes of corporation tax -

(a) the profits and gains arising from the loan relationships of a company, and

(b) any deficit on a company's loan relationships,

shall be computed in accordance with this section using the credits and debits given for the accounting period in question by the following provisions of this Chapter.

...

93 Relationships linked to the value of chargeable assets

(1) This section applies in the case of any loan relationship of a company that is linked to the value of chargeable assets unless it is one the disposal of which by the company would fall to be treated as a disposal in the course of activities forming an integral part of a trade carried on by the company.

(2) The amounts falling for any accounting period to be brought into account for the purposes of this Chapter in respect of the relationship shall be confined to amounts relating to interest.

...

(6) For the purposes of this section a loan relationship is linked to the value of chargeable assets if, in pursuance of any provision having effect for the purposes of that relationship, the amount that must be paid to discharge the money debt (whether on redemption of a security issued in relation to that debt or otherwise) is equal to the amount determined by applying a relevant percentage change in the value of the chargeable assets to the amount falling for the purposes of this Chapter to be regarded as the amount of the original loan from which the money debt arises.

...

(9) If -

(a) there is a provision which, in the case of any loan relationship, falls within subsection (6) above,

(b) that provision is made subject to any other provision applying to the determination of the amount payable to discharge the money debt,

(c) that other provision is to the effect only that the amount so payable must not be less than a specified percentage of the amount falling for the purposes of this Chapter to be regarded as the amount of the original loan, and

(d) the specified percentage is not more than 10 per cent,

that other provision shall be disregarded in determining for the purposes of this section whether a relationship is linked to the value of chargeable assets.

103 Interpretation

(1) In this Chapter -

...

'debt' includes a debt the amount of which falls to be ascertained by reference to matters which vary from time to time;

'debtor relationship', in relation to a company, means any loan relationship of that company in the case of which it stands in the position of a debtor as respects the debt in question;

...

'loan' includes any advance of money, and cognate expressions shall be construed accordingly;

."

6. The two provisions relevant in relation to capital gains tax are:

(a) in the Income and Corporation Taxes Act 1988:-

"128 Commodity and financial futures etc: losses and gains

Any gain arising to any person in the course of dealing in commodity or financial futures or in qualifying options, which [is not chargeable to tax in accordance with Schedule 5AA and] apart from this section would constitute profits or gains chargeable to tax under Schedule D otherwise than as the profits of a trade, shall not be chargeable to tax under Schedule D.

In this section 'commodity or financial futures' and 'qualifying options' have the same meaning as in section 143 of the 1992 Act, and the reference to a gain arising in the course of dealing in commodity or financial futures includes any gain which is regarded as arising in the course of such dealing by virtue of subsection (3) of that section."

The words in square brackets were inserted by the Finance Act 1997 with effect for chargeable periods ending after 4 March 1997 in respect of profits or gains realised after that date. Schedule 5AA concerns guaranteed returns on transactions in futures and options: neither side contended that it was material.

(b) in the Taxation of Chargeable Gains Act 1992: -

"143 Commodity and financial futures and qualifying options

(1) If, apart from section 128 of the Taxes Act, gains arising to any person in the course of dealing in commodity or financial futures or in qualifying options would constitute, for the purposes of the Tax Acts, profits or gains chargeable to tax under Schedule D otherwise than as the profits of a trade, then his outstanding obligations under any futures contract entered into in the course of that dealing and any qualifying option granted or acquired in the course of that dealing shall be regarded as assets to the disposal of which this Act applies.

(2) In subsection (1) above -

(a) 'commodity or financial futures' means commodity futures or financial futures which are for the time being dealt in on a recognised futures exchange;

...

(3) Notwithstanding the provisions of subsection (2)(a) above, where, otherwise than in the course of dealing on a recognised futures exchange -

(a) an authorised person or listed institution enters into a commodity or financial futures contract to with another person, or

(b)...

then, except in so far as any gain or loss arising to any person from that transaction arises in the course of a trade, that gain or loss shall be regarded for the purposes of subsection(1) above as arising to him in the course of dealing in commodity or financial futures.

."

The authorities

7. The following decisions were cited in argument:-

Webb v Stenton (1883) 11 QBD 518;

London Financial Association v. Kelk (1884) 26 Ch D 107;

McEntire v Crossley Bros. Limited [1895] AC 457;

Smart v Lincolnshire Sugar Co Limited (1936) TC 643;

IRC v Wesleyan and General Assurance Society (1946) 30 TC 11;

Bronester Limited v Priddle [1961] 1 WLR 1249;

Chow Yoong Hong v Choong Fah Rubber Manufactory [1962] AC 209;

Marren v Ingles (1980) 54 TC 76;

Burnes v Trade Credits Limited [1981] WLR 805;

Street v Mountford [1985] AC 809;

West Deutsche Landesbank Girozentrale v Islington London Borough Council [1996] AC 669;

Welsh Development Agency v Export Finance Co Limited [1992] BCLC 148;

Lloyds & Scottish Finance Limited v Cyril Lord Carpet Sales Limited [1992] BCLC 609;

Bibby v Prudential Assurance; Oakes v Equitable Life Assurance [2000] STC 459;

Griffin v Citibank Investments [2000] STC 1010;

Macniven v Westmoreland Investments Limited [2001] 2 WLR 377; [2001] STC 237; [2001] UK HL 6;

Manufacturers' Life Assurance Co v Cummins [2001] STC 316;

DTE Financial Services v Wilson [2001] STC 777.

The representative transactions

8. All the transactions have in common that they were made with reference to life insurance products under which the sums payable to investors are linked to the performance of a share index but with the risk element of that link eliminated or reduced by a guaranteed minimum payment. The product was normally in the form of a life assurance policy for five years and described as a guaranteed equity bond (GEB). A variation on this formula consisted of bonds with regular income-type payments during their life (ELIBs). Because the bonds were life

assurance policies, the death of the bondholder before maturity would trigger payment of the amount due at maturity but by reference to the index at the time of death. Enormous sums were invested by the public in these bonds, the estimate given us by the appellants being that in excess of £4.5 billion was involved.

9. It is not the tax treatment of these policies themselves which is at issue but that of the contracts [investments] made by the Life Offices to enable them to make good their obligations to bondholders. In outline, the Life Offices usually took the following steps:

1. the purchase from an authorised dealer of a derivative matching the Life Office's liability - and sometimes exceeding it in order to provide also for the Life Office's tax liability;

2. a deposit of cash by the derivatives dealer with the Life Office equivalent to the price paid for the derivatives contract as security for the dealer's obligations under it;

3. the redeposit of that cash by the Life Office with various financial institutions, including (as to up to 10% of it) the derivatives dealer which had made the deposit with the Life Office;

4. a put option exercisable by the Life Office enabling it to compel the derivatives dealer to buy the shares which were usually (see below) to be delivered under the derivatives purchase contract;

5. a two-way compensation agreement between the Life Office and the dealer under which the latter would as the agent of the Life Office, if requested, sell the shares which had been put onto it.

10. There are four types of closing out possible as a result of the combination of instruments in the specimen transactions before us: (i) those to be settled in shares but with an option to take cash;(ii) those to be settled in cash but with an option to take shares; (iii) those to be settled solely in cash; (iv) those to be settled in shares. There is no dispute about the tax treatment of the various deposits and loans, and it is common ground that the security provided by steps two and three was a prudential requirement of the statutory regulator (then the DTI, and now the FSA), as was step four so that bondholders might be assured of having the amount needed to satisfy their entitlements.

11. It is contended by the taxpayers (i) that these transactions do not fall within the loan relationship provisions of the Finance Act 1996 and that there were consciously so arranged as not to do so; (ii) that the Inland Revenue originally held the view that such transactions did not involve the lending of money, and said so both in a letter in response to an enquiry from a leading accountancy firm and in their own internal Life Assurance Manual; and (iii) that the transactions are, in any event, saved from the loan relationship legislation by section 128 of the Income and Corporation Taxes Act 1988. The Crown deny that the expressions of view relied on are material to the appeal, and argue that the transactions fell within the loan relationship legislation in the 1996 Act, and are not excluded therefrom by section 128.

12. The documentary evidence occupied sixteen lever-arch files whose contents, together with the lengthy oral evidence we received, cannot be rehearsed in detail; we have been obliged to distil from it what appear to us to be the essential points. The parties had prepared no core bundle but, at our request, produced a bundle following the hearing containing six specimen or typical transactions upon which we are invited to make findings which can be extrapolated to the other transactions under appeal. This is, accordingly, an initial determination in principle only, and further determinations may be required in relation to specific transactions. The complete corpus of evidence remains of course available and was formally before the tribunal.

13. Evidence was given on behalf of the various appellants and their counterparties as follows:-

- for HSBC Life (UK) Limited, Andrew Millard, the Finance Director of the company and its Appointed Actuary, while also being the Head of Actuarial and Risk for the bank's

Personal Financial Services Division; and Katherine Garner, who was risk management actuary and is now on secondment to Dublin as acting Head of Operations with HSBC Life (Europe) Limited and as its Finance Director;

- for Nationwide Life Limited, James Coleman who is the Society's Assistant Treasurer;

- for Abbey Life Assurance Company Limited, Derek McLean who was at the time a director of Abbey Life Investment Services but, since October 2000, has been the Product Management Director of Foreign & Colonial Management Limited and is a member of the Derivatives Working Party of the Association of British Insurers; and Dr Michael Green, who is the company's Appointed Actuary and Deputy Managing Director;

- for TSB Life Limited, John Eccles, who is a chartered accountant and Head of Shareholder Investment, but formerly the Head of Treasury; and Neil Dunn, who was Life Development Actuary for Lloyds TSB Life Assurance Company Limited and is now working in Lloyds TSB Group's Risk Management and Compliance function;

- for Lloyds TSB Life Assurance Company Limited, Stephen Marsh, who worked in the Actuarial Development, Corporate Actuarial and Risk Management functions of the company until 1999 when he joined the staff of the FSA within the Insurance and Friendly Societies Division (but has no responsibility for the supervision of the company);

- for HSBC Bank Plc, Dr Robert Benson, who was Head of the bank's Retail Products Group and now works for the bank on an occasional consultancy basis and is to start working this year at the Centre for Quantitative Finance at Imperial College, London;

- for Union Bank of Switzerland, Mark Ellis, who is a registered representative of the FSA, and is presently Head of Derivatives Marketing at Abbey National but, until 1998, was Managing Director of UBS;

- for Lloyds Bank Plc, Tamlyn Nall, who is the Product Development and Structured Finance Director.

All of the above apart from Neil Dunn and Tamlyn Nall, whose written statements were accepted, gave oral evidence.

14. In addition to these witnesses, we received the expert report and oral evidence of Dr Jeffrey Golden, who is admitted in the states of New Jersey and New York, and at the bar of the United States Supreme Court; he is a partner

in the City practice of Allen & Overy, in the firm's International Capital Markets Department and co-Head of Allen & Overy's US law practice worldwide and of its derivatives practice group. Dr Golden is a legal adviser to the International Swaps and Derivatives Association and has extensive published work on derivatives and swaps; he has served on numerous official working parties and study groups.

The issues

15. Having heard the evidence and the submissions for the Appellants Mr Henderson stated that the area of dispute had narrowed and was confined to the main hedging instruments for capital benefits payable to investors on maturity.

1. The appeals only concerned accounting periods ending after 31 March 1996;

2. There was no dispute as to the tax treatment of any of the margining transactions;

3. There was no dispute as to any of the stand alone derivatives relating to tax;

4. There was no dispute as to any of the transactions hedging the income benefits payable to policyholders under the Equity Linked Income Bonds (ELIBs).

The questions of law we identify as necessary for our decision in relation to the transactions under appeal are as follows:-

(i) do the transactions constitute "money debts" within the meaning of sections 81 and 103, even where they are, in the first instance, to be settled otherwise than in cash; and does "falls to be settled" in section 81(2) mean: "is, in the event, settled" or "is, when contracted, due to be settled", or "is, in each relevant accounting period, due to be settled"?

(ii) are the transactions ones "for the lending of money" such that there was a loan relationship within the meaning of section 81(1)?

(iii) do the transactions, if not loans, constitute "any advance of money" within the meaning of section 103?

(iv) are the transactions properly the subject of a Ramsay analysis, in accordance with the latest restatement of that approach in Macniven?

(v) is the letter from Dr Williams of the Inland Revenue to KPMG a relevant or admissible aid to construction of the loan relationship legislation?

(vi) is section 128 of the Taxes Act 1988 applicable?

Findings of Fact

16. The documentary evidence of the transactions under appeal was very detailed, extensive and complex. They are not in themselves in dispute, that is to say that no issue is taken with the veracity or authenticity of the documents, nor of course is it argued that the transactions they describe were not entered into. It is, accordingly, not necessary at this point to give more than an outline of them and of their effect.

The nature of the financial forward transactions under appeal

17. Dr Golden's evidence was that he regarded a financial futures contract as one which obliges one party to sell and the other to purchase a specific underlying asset at a specified price (agreed at the time of entering into the trade), on a specified future date. A "future", he said, is characterised by the buyer's entitlement to exercise its rights under the contract, irrespective of what its economic position is when it comes to do so.

18. In the particular sense used in section 143(2) of the Taxation of Chargeable Gains Act 1992, a financial future would be a future in which the underlying rights and obligations of the parties relate to the payment of a cash amount calculated on the basis of a financial instrument or asset, such as a share or share index, and not of a commodity. Although physical delivery is still used in some financial markets futures contracts, many are now cash-settled: instead of delivering the underlying asset, the buyer receives (or the seller pays) the difference between the contract price and the then prevailing underlying market price of the relevant asset.

19. The various terms are, said Dr Golden, often used with some inconsistency across different markets to mean similar but not identical things, but these were the basic features of the financial future. The term "future" is nearly always used in the UK and US markets to describe exchange-traded products; the same product, or a more bespoke version of it, traded over the counter would more ordinarily be referred to in the same markets as "an OTC forward". Contracts with materially the same terms as futures contracts which are not dealt in on an exchange are usually referred to as "forward transactions".

20. Dr Golden was specifically asked his opinion on whether initial payment (as opposed to payment on maturity) by the buyer under such a contract would affect or qualify his general views. In response to this he said that the

characterisation of a futures or forward transaction depends largely upon the nature of its obligations, the way the transaction is entered into, the form and substance of the documentation used and the way the transaction is traded. Dr Golden added, in his expert report, that the timing of payments by a party under a transaction would not usually affect its characterisation, but he agreed in oral evidence that in a financial futures contract the payment of the entire price by one party to the other at the beginning of the transaction is "probably not very common".

The ISDA Master Agreement

21. The terms of this agreement were incorporated by reference into four of the six representative transactions, and it is therefore convenient to refer to it on its own.

22. The ISDA Master is a standard-term agreement drawn up by the International Swap Dealers Association, now renamed the International Swap and Derivatives Association. The version used was that for multi-currency cross-border deals and is of some complexity; it is the result of much advice and consultation in the various jurisdictions in which it operates. The Agreement is intended to provide an immediate and commonly accepted basis of dealing in the fast-moving financial futures markets and is supplemented by what Dr Golden described as a library of ISDA definitions, which amount to an explanatory and authoritative commentary on the Agreement.

23. Besides the Agreement itself with its standard provisions, there is always a schedule in each case in which is contained variations agreed between the parties and particulars material to their relationship, and - deal by deal - specific confirmations in which the economic terms agreed for the deal are recorded. The Agreement is usually adopted in this way before a course of dealing begins so that, when the moment comes for transactions to be concluded against a tight time schedule the basis for doing so is already there.

24. A fundamental feature of the ISDA Agreement is that each obligation of each of the parties under it is conditional upon no "event of default" having occurred and continuing, and that no early termination date has been triggered. There is also a detailed set of netting-off provisions designed to ensure that payments by or to each party reflect the sum of the obligations of each one toward the other. The "events of default" include a failure by either party to make payments on due dates, to perform obligations under the Agreement, bankruptcy, and merger of one party with a third party who does not assume the obligations under the Agreement. Likewise, there are termination events such as a supervening illegality and the happening of various tax events.

25. The effect of these provisions is that a transaction may be unwound at any stage before its term and without the parties specifically wishing it to be. The final outcome of transactions governed by the ISDA Agreement is not therefore certain, even in principle. The structure of ISDA Master Agreement deals is that the Life Office at the outset makes a fixed payment to the counterparty, expressed as a percentage of a fixed notional amount; at maturity of the index-linked transaction, the counterparty discharges its obligation to the Life Office, either in cash or in shares depending on the terms of the bargain.

1 - The Abbey Life 'Equity Forward' Transaction

26. The ISDA Master Agreement covering this was dated as of 22 January 1996, though it was signed on behalf of the parties on 6 and 10 June 1996 (indicating perhaps that it was in part recording the common basis upon which deals had already been made), which were also the dates on which the Schedule was signed. The Schedule, seven pages long, made numerous alterations to the standard terms and specified as the counterparty the Union Bank of Switzerland.

27. The confirmation of the specimen transaction put forward was 14 pages long and stated to be by reference to the Master Agreement; it was dated 4 October 1996, and related to a trade actually done on 30 May 1996, but effective from 27 August 1996. The seller was UBS and the buyer Abbey Life and the settlement was to be on 27 October 2001 in UBS bearer shares valued by reference to the level of the index (as defined) on 26 September 2001, but to be the same as the cash settlement amount; the amount invested by bondholders was £5,826,000 and the price to the Life Office of the forward was £5,180,653.38. There were three different elements specified as "monthly income", "annual income" and "growth", intended to match the different types of payment flows to the relevant policyholders, who had the option of receiving monthly or annual income, or of taking a capital growth bond.

28. Next, for the same transaction, is a put option for a consideration of £1,000 (described as "European style") also dated 4 October 1996, but with a trade date of 30 May and an effective date of 27 August 1996, enabling the Life Office on 26 September 2001 to put onto UBS some or all of the shares to which it would become entitled under the derivatives bargain, with provision for ascertaining the cash price which they would fetch. It was so worded as to eliminate any risk for the Life Office which might arise from the latter being unable to sell the relevant shares in the market at the same price.

29. This was accompanied by a Margin Loan Transaction, with the same actual, trade and effective dates, under which UBS lends to the Life Office £113,076 by annual

instalments, which are repayable only on 27 October 2001. Its purpose was to enable the Life Office to make monthly and annual payments of income to those investors who had chosen the corresponding bonds. On the same date there is a "two-way compensation" agreement between the same parties, under which the Life Office could require UBS acting as its broker to sell the shares it had the right to put onto UBS under the put option; it is common ground that this agreement existed purely to avoid possible adverse tax consequences in exercising the put option.

30. This, in turn, is followed by a collateral monitoring agreement dated 17 February 1997 between the same parties and Citibank N.A., a national banking association, as the collateral monitor of the transactions, and a security deed also dated 17 February 1997 under which UBS Limited (a wholly owned subsidiary of Union Bank of Switzerland) charged securities - in this case, UK negotiable debt obligations, shares in companies in the FTSE-100 Index and cash - in favour of the Life Office as security for the performance of the bank's obligations to the Life Office. A side letter, also dated 17 February 1997, from the bank to the Life Office related to the delivery obligations under the charge. The arrangement was designed to hedge one party's exposure to the other's creditworthiness, and minimise the credit risk associated with a failure of performance.

31. The basic trades would have been made by telephone and recorded in notes, of which the documents are the fleshed-out record. At first sight, the mismatch in dates suggests the possibility of history having been rewritten, but we are satisfied that there is nothing sinister in the mismatch and that it was normal for the documentation of transactions of this sort in the financial markets to follow the event; indeed, Dr Golden's evidence was that the frequency with which time lags occurred was such that concern was being expressed by regulators in the markets about the disorderliness of it. But we find that it does not cast doubt on the authenticity of the transactions but, on the contrary, tends in the circumstances to vouch for it.

32. Where there were partial buy-backs (where a policyholder surrendered his policy early) the Life Office would often take UBS shares rather than cash, especially if the market was right for that and the cashflow allowed, but otherwise a cash receipt from UBS was the usual outcome - cash on maturity of an entire bond issue being needed in sizeable quantities in order to settle the entitlements of the bondholders on the due date, there being an obvious danger in taking a very large holding of shares that the market might move adversely after payments had become due but before the shares had been sold. Indeed, the admitted evidence was that the practice of taking shares on partial buy-backs was "almost certainly" driven by tax considerations i.e. to bolster the argument that the right to

shares was there as a genuine commercial entitlement which the Life Office might wish to exercise.

33. In connection with other trades done with Lloyds Bank as the counterparty, there was a board resolution passed on 11 November 1996 that Abbey Life "has no intention of exercising the option to take shares as currently contained in the various financial futures contracts entered into between the company and Lloyds Bank Plc"; that was passed in order to provide an argument in defence of any claim for stamp duty reserve tax, and appears not to have been rescinded. It does not bear directly on this representative transaction, but it does reflect, we find, the practical certainty that existed in any event that the Life Office would opt for cash rather than shares at term, although the right to take shares instead remained.

2 - The HSBC Life (former Midland Life) 'ELIB' Financial Futures Transaction

34. This transaction was in rather briefer form, and designed to support HSBC Life's Equity Linked Income Bond, with a guaranteed annual income of 7.5% and a final maturity value linked to the FT-SE 100 Index. It was not based on the ISDA Master Agreement, but was the subject of a Financial Futures Agreement dated 29 November 1993, effective from 1 December 1993, between the Life Office and Midland Bank Plc, under which the Life Office purchased futures for £67,832,276, the maturity payment of which matched the index-linking of the bondholder's entitlement by reference to a complex formula to calculate the "intrinsic value" of the contract, to be paid on 1 December 1998. The effect of the formula used in the Financial Futures Agreement was that HSBC would always receive from the bank both an amount equal to the sums due to bondholders and an amount equal to its own tax liability, the minimum due to it being some £76 million. It was put into effect by a single page undated confirmation letter. Settlement was to be in cash.

35. The Financial Futures Agreement was linked to a Loan Agreement of the same date (called the ELIB(2) Loan Agreement) between Midland Life Limited and Midland Bank Plc, and Deposit Agreement and a Netting Agreement likewise. The purpose of these agreements was to ensure that HSBC Life would be able to meet its obligation to pay bondholders the guaranteed annual income of 7.5%, plus an amount to cover the Life Office's tax liability, and to limit HSBC Life's exposure to the bank in order to meet the prudential requirements applicable to it. Mr Millard's evidence was that these original arrangements were altered in September 1995 for reasons of which he unaware, but possibly to match the payment obligations to bondholders more closely.

36. In his evidence about this transaction (including

others), Mr Millard agreed that the Life Office needed, at the end of the term, a sum of money equal to its obligation to investors - and its own tax liability - and that the only variable in the series of transactions was the value of the FT-SE Index at maturity, which would be ascertained by averaging the levels of the index over the final twelve-month period. Overall, the effect of the ELIB bond was that, even if the FT-SE 100 Index did not move, or fell, there would a return of the original investment taking into account the income payments and the sum payable on maturity.

3 - The HSBC Life (formerly Midland Life) GCB(2) Financial Futures Transaction

37. This transaction was to support the Guaranteed Capital Bond, a single premium index-linked endowment policy with a term of five years which contained a money-back guarantee or growth of 110% of any increase in the FT-SE 100 Index on 95% of the premium.

38. The backing arrangements for this bond were identical to those described for transaction 2 above, and with the same dates, except of course that the provisions designed to relate to the interim income flows were not necessary; settlement was to be in cash. They were supplemented by a call spread option bought from Midland Bank by the Life Office on 14 January 1994 to provide for a significant potential tax liability which had emerged and which would not have been covered by the financial future.

4 - The Lloyds TSB Life (formerly Black Horse Life) Transaction

39. This was based upon an ISDA Master Agreement along the same lines as that discussed in transaction 1. It was dated as of 9 June 1994, and the relevant confirmation of trade was dated 5 December 1996 referring back to a trade actually concluded on 15 March 1996 with effect from 18 March 1996. Unusually for transactions pursuant to the ISDA Master, settlement was to be in cash with the Life Office being entitled to elect for shares under a call option entered into with the counterparty UBS on 3 September 1997; that option was taken because of concern at the time about stamp duty reserve tax, but also because of concern that the loan relationship legislation might be applicable otherwise. A Margin Deposit Agreement and a deed of security, serving the same purposes as in the previous cases, completed this transaction.

40. The transaction backed a six year unit-linked endowment with two options: Maximum growth, under which the bondholder received the greater of his investment or 100% of any growth in the FT-SE 100 Index; or secured growth, the investor receiving the greater of 135% of the investment or 50% of any growth in the

Index.

5 - The Nationwide Life OTC Basket Option Transaction

41. This was again written under an ISDA Master Agreement and was designed to back the Nationwide's Worldwide Guaranteed Equity Bond, which provided for a minimum return of the bondholder's investment plus any bonus linked to the performance of six equity market indices in various countries.

42. The ISDA Master was dated as of 11 September 1996 and the trade in question was recorded in a confirmation dated 13 January 1998 but made on 15 September 1997, effective from 18 September. That was subject to a revision on 5 February 1998. Settlement was to be in shares on the Paris, Frankfurt, Milan, Amsterdam, New Zealand or Toronto exchanges. There was no option to take cash. Mr Coleman said in his evidence that the Life Office did not want shares at the time they had to pay bondholders; it wanted cash: the entitlement to shares was there purely for tax reasons. In other cases where there was a put option in favour of the Life Office, that was why it was there.

6 - The TSB Life Equity Forward Transaction

43. This was also written under an ISDA Master Agreement and was designed to back TSB Life's Guaranteed Stock Market Bond - a single premium investment for a fixed term offering a guaranteed return of the initial premium and the prospect of participation in any growth in the FT-SE 100 Index.

44. The ISDA Master was dated as of 13 December 1996, with a Credit Support Annex likewise made between Lloyds Bank Plc and TSB Life. The actual trade was made on 18 December 1996, and provided for settlement on 19 February 2002 by means of a basket of shares representing the Index, with a call option (granted on 9 April 1998) in favour of the Life Office to ensure the availability of cash in lieu. Mr Eccles in evidence agreed that the primary entitlement to shares with the secondary entitlement to cash was a tax driven choice, though there might in certain circumstances have been a commercial interest in taking the shares. The need for cash on maturity to pay bondholders was not absolute, the Life Office being a large one and having considerable resources at its disposal at any one time.

The letter from Dr Williams of the Inland Revenue to KPMG

45. Dr Michael Green exhibited to his witness statement a letter from KPMG to Dr Diane Williams of the Revenue's Financial Institutions Division dated 17 May 1996 and of her reply dated 3 June 1996. Dr Green said that he

specifically recalled seeing this exchange at or around the time it occurred and that, in the light of it, Abbey Life decided to restructure certain of its existing contracts. The correspondence was as follows:-

"Dear Dr Williams,

FT-SE 100 contract - implications under the new corporate debt regime

I am writing further to our telephone conversation yesterday.

I gave an example of a UK corporate investing, on non-trade account, in a FT-SE 100 forward contract as falling within s81 FA 1996 (meaning of loan relationship etc). In particular, would the facility to settle the contract by way of cash and/or a minimum guaranteed return create a loan relationship?

My understanding is that the Inland Revenue would take the following view.

1 Whether the contract is settled by money or by physical delivery of shares, and irrespective of any minimum guaranteed return, there is no debt, only consideration payment. Accordingly, there is no 'money debt'.

2 Even if there is a money debt, that debt would arise from a FT-SE 100 contract, not from the lending of money. And there is no deemed 'lending of money' because a security is not issued. Accordingly, there is no loan relationship.

3 FA 1994 should not be in point as the contract is not an interest rate or currency contract. Neither should it be regarded as a contract on a loan relationship.

4 The contract should be taxed under capital gains rules.

I would be grateful if you could confirm my understanding or comment otherwise.

Yours sincerely,

Dhiresh Shah

Tax Senior Manager"

"Dear Mr Shah,

FT-SE 100 Contract

I refer to your letter of 17 May 1996.

I can confirm that the position set out in your letter is correct. Where a UK corporate invests, on a non-trading basis, in a FT-SE 100 forward contract there is no transaction for the lending of money. The forward contract is not a loan relationship. The assets underlying the contract are shares which are assets which are subject to the chargeable gains rules. The forward contract is also subject to the capital gains regime for corporation tax purposes.

Yours sincerely,

Diane M Williams"

46. It was asserted in Mr Aaronson's skeleton, and not contradicted, that paragraph 4.42C of the Inland Revenue's Life Assurance Manual reads:-

"Companies carrying on life assurance business may use novel varieties of derivatives to back bonds. Where the bond itself is limited to providing a growth return after a period of years, based on the rise in a stock exchange index such as the FTSE 100, Standard & Poors or DAX, and purchases derivatives based on these indices, then we would not regard these transactions as abusive, so long as a chargeable gain was returned on disposal."

Thus presented, this is not of course strictly admissible evidence, but nothing turns on this extract alone and we include it for the sake of completeness.

Conclusions

(i) Do the transactions create "money debts"?

47. We consider first the question whether "falls to be settled" in section 81(2) requires the analysis of the transaction to be carried out when it is entered into, or when it is finally discharged, or at some other time.

48. For the taxpayers, it was argued that the first meaning is the most obvious and the most satisfactory. If the applicability of the loan relationship legislation is to depend, as it must, upon a legal analysis of the rights of the parties then what the parties have clearly contracted for must be determinative: "falls to be settled" means "required" to be settled, and refers to the rights and obligations created by the parties rather than any variation of them which they might or might not subsequently undertake. For the Crown, Mr Henderson submitted that the matter must be looked at both initially, and then in each period of account, to see if it had changed because it is by reference to such periods that the existence or otherwise of a loan relationship must be

determined; it could not be otherwise in the case of what is, in principle, an annual income charge to tax on the profits of a trade.

49. The phrase "falls to be settled" might have read "in the event is settled" and, if it did, it would be a comparatively straightforward matter in this appeal to look at the actual outcome of each transaction and see whether the settlement was ultimately in cash; and it nearly always was. Convenient though that solution would be, it is not what the statute says, and neither counsel supported it: it would, for the reasons Mr Henderson gives, be inconsistent with the scheme of sections 82-90, which require the profits and gains arising from loan relationships to be computed each year by reference to the accountancy principles there described.

50. A difficulty with the intermediate sense of the phrase, which requires the form of settlement to be examined afresh in each accounting period, is that it leaves open at what point in that period the snapshot must be taken, and could perhaps necessitate a view being taken each year as to the probable form in which settlement will take place; and in some of the transactions we saw, there had been material changes to the entitlements before the maturity date.

51. Mr Henderson's reply to this was that, having examined the position at the outset of the relationship between the parties, it would subsequently be a question of establishing whether there had been a material change in their intentions as to how their obligations should be settled. When it was put to him that doing this could present very considerable difficulties in practice, Mr Henderson's answer was that difficulty would only be encountered in the one case out of a hundred in which the Inspector was put on enquiry because it was apparent that the legal form had been adopted for purely tax reasons; the exercise was one which was required only when the case fell into the field of potential tax avoidance.

52. The appropriateness of the Ramsay approach in this case is examined below, but in terms of conventional statutory construction the interpretation favoured by Mr Aaronson - looking at the matter in terms of the rights and liabilities established between the parties, and eschewing speculation as to what they "really" intend - appears both more workable and more exactly to fit the wording of the statute; the phrase used is not "may fall to be settled". Unless there is a definite variation in the rights of the parties during the lifetime of the transactions, the question whether they create an entitlement to cash must be answered when they are entered into. There could, it is true, be the difficulty that an agreement initially within the loan relationship provisions in one year could be said to fall outside them the next year, and to be instead within the

scope of capital gains tax - and vice-versa; but we note that Mr Henderson accepted that the possibility of a debt relationship coming in and out of the legislation is one that is contemplated by it.

53. Mr Aaronson accepted that, where the transactions are due only to be settled in cash, there is a money debt within the meaning of section 81(1). That is the case with the two HSBC Life transactions mentioned above. Where the transactions were not, unless options were exercised, to be settled in cash, Mr Henderson's main argument that they represented money debts was based on the applicability of the Ramsay approach, which is dealt with below; he accepted that section 93, which contains specific provisions relating to loan relationships linked to the value of chargeable assets, is not applicable to the present case.

54. We conclude - without reference to the Ramsay approach - that the transactions should be analysed in terms of the legal relations they did establish. It follows, therefore, that where settlement was to be in cash only, the transactions created money debts; where settlement was to be in shares only, no money debt was created; where it was to be in shares with an option to take cash, no money debt was created until and if that option was exercised; and where they were to be settled in cash with an option to take shares, a money debt was created and existed until and if the share option was exercised.

(ii) Are the transactions ones for the lending of money?

55. In respect of any transactions falling within the meaning of "money debts", it must then be considered whether they are transactions "for the lending of money", the two requirements in section 81(1) being cumulative.

56. No argument was advanced to the effect that the derivatives agreements, the put options or the two-way compensation agreements were, individually or together, "an instrument . issued by any person for the purpose of representing ... the rights of a creditor in respect of any money debt" within the meaning of section 81(3), either on the basis of the Ramsay approach or otherwise, and we therefore make no finding on that issue.

57. It is in our view self-evident that if a transaction is "for the lending of money", it must involve a loan. It must be

decided, therefore, what constitutes a loan? Section 103 merely states that a loan includes "any advance of money" (which we consider separately below) and that "debt" includes "a debt whose amount is ascertained by reference to matters which vary from time to time"; in other words, "debt" is not restricted to cases in which the amount of money lent is inevitably the same as the amount to be repaid. The concept therefore includes debts where the principal involved may vary, which is already a departure from the classic conception of a loan in which, though the interest may vary, the principal lent and repaid is fixed.

58. Section 81(1)(b) however states in terms that the debt must arise "from a transaction for the lending of money." In our view this must involve both a lender and a borrower. The term "relationship" implies that the parties to it are respectively borrower and lender and, as section 81(1)(a) makes clear, stand in the position of creditor and debtor as respects the debt. While the concept of loan which is intended in Chapter II of Part IV is evidently to be a wide one, there is nothing to suggest that the legislature had in mind an entirely different concept, or that "loan" should be taken to include transactions which are not in the nature of lending and borrowing. It must be possible to say that one party is recognisably lending money - on whatever terms - and that the other party is borrowing it.

59. It is true that section 81(4) - which provides that the rights conferred by shares in a company shall not be taken to arise from the lending of money - could be seen as indicating that, for example, the purchase of redeemable preference shares would create a loan relationship if such a case had not been specifically excluded. On that view, the fact that something could be characterised as an investment would not necessarily prevent it amounting also to the lending of money. There could thus be an argument that certain investments come within the wide concept of a loan relationship. But it is sufficient to explain the purpose of subsection (4) to say that it is obviously desirable that the position of so important an area of commercial life as the purchase and sale of shares should be put beyond doubt: it does not show that there is an argument a contrario that the rights created by shares in a company would otherwise establish a loan relationship.

60. Some considerable effort was made by Mr Henderson to demonstrate in each case that the transactions were ones in which, bearing in mind especially the effect of the deposit back to the Life Offices of the sums they had just paid their counterparties for derivatives, the deal overall was one in which the risk to capital was eliminated and the only uncertainty was the amount of the gain; the amount of the gain, on that analysis, would represent variable interest on what was effectively a loan of the principal sum. That would bring the case well within the extended meaning of "debt" in section 103, on the basis of which even the

amount of the principal might vary. But this approach does nothing to answer the question: is there a lending of money? Many transactions could fall within a literal reading of the criteria in section 103, but that does not show that they are transactions for the lending of money.

61. For the Crown, reliance was placed on the categories of transaction recognised in Chitty on Contract as loans. Beginning with the caveat that "it would be unsafe to assume that a transaction which would be classified as a loan for the purposes of one statute will necessarily be so classified for the purposes of other statutory provisions" (paragraph 38-221), Chitty goes on (at paragraphs 38-224/5) to distinguish, by means of examples from the authorities, loans from other forms of debt. Not loans are: credit purchases, the issue of loan or debenture stock as consideration for the acquisition of property, the purchase of bills or book debts at a discount or hire-purchase transactions. Borderline cases cited, where it is difficult to determine whether loans are being made, are certain types of instalment credit transactions such as check and voucher trading, revolving shop credit accounts and credit cards. We derive only limited help from *Chitty.*

62. We are assisted in deciding whether or not what purports to be other than a loan is in law a loan by an impressive sequence of authorities in the House of Lords and the Privy Council.

63. We note first, in this context, the judgment of the Privy Council in Chow Yoong Hong v Choong Fah Rubber Manufactory [1962] AC 209, concerning as it does the precise question whether transactions which could be described as having an economic effect comparable to that of a loan should be so regarded when the parties had nonetheless not entered into a loan transaction.

64. That case concerned the purchase of bills at a discount and the giving by the purchasers of the bills to the sellers post-dated cheques. For opportunistic reasons, the purchasers of the bills subsequently sought to characterise these transactions as loans. It was accepted that the purchases at a discount and the giving of the post-dated cheques in return had indeed taken place. Lord Devlin, giving the judgement of the Board, said (at page 215) that:-

"The business of buying bills at a discount, that is, for their value at the date of purchase, is well known and quite distinct from that of moneylending. ... There is no loan and no promise of repayment."

65. In that case, the claim that the transactions were loans was supported by reference to a statutory definition of "interest" as including "any amount by whatsoever name called in excess of the principal payable or paid to the

moneylender in consideration of or otherwise in respect of a loan". In relation to this, Lord Devlin added, at page 216:-

"Even if the post-dated cheques did produce an excess [i.e. were worth more than the bills for which they were given], that is not 'interest' within the definition unless there is a loan. As in the case of the second group of transactions, their Lordships have looked in vain in this first group for anything that can fairly be represented as a lending of money by the plaintiff and the promise to repay. The fundamental error that underlies the defendants' case on both groups of cheques is that because they were, so they say, in need of ready cash, and because the plaintiff supplied them with it and made, if he did, a profit out of doing so, therefore there was a loan and a contract for its repayment. There are many ways of raising cash besides borrowing. One is by selling book-debts and another by selling unmatured bills, in each case for less than their face value. Another might be to buy goods on credit or against a post-dated cheque and immediately sell them in the market for cash.

Their Lordships are, of course, aware, as was Branson J., that transactions of this sort can easily be used as a cloak for moneylending. The task of the court in such cases is clear. It must first look at the nature of the transaction which the parties have agreed. If in form it is not a loan, it is not to the point to say that its object was to raise money for one of them or that the parties could have produced the same result more conveniently by borrowing and lending money. But if the court comes to the conclusion that the form of the transaction is only a sham and that what the parties really agreed was a loan which they disguised, for example, as a discounting operation, then the court will call it by its real name and act accordingly."

66. That approach was firmly in line with the House of Lords' formulation of the court's task made in a much earlier case cited to us, McEntire v Crossely Bros Limited [1895] AC 457, a case in which argument had been advanced that the effect of a hire-purchase agreement had been to transfer the ownership of a chattel rather than merely to lease it. At page 463, Lord Herschell L.C. said:-

"But there is no such thing, as seems to have been argued here, as looking at the substance, apart from looking at the language which the parties have used. It is only by a study of the whole of the language that the substance can be ascertained. ... if the appellants could have pointed here to any provisions in this deed inconsistent with the intention that the property should remain in the vendors, I think they might very likely have succeeded, notwithstanding that the parties had in terms said what their intention was."

At page 467, Lord Watson's statement of the court's function was:-

"As is usual in cases of this kind, we have heard a great deal in the course of the appellants' argument of the necessity of attending to the substance of the agreement which we have to construe. My Lords, that is a canon of construction which is applicable to all agreements; but it must always be borne in mind that the substance of the agreement must ultimately be found in the language of the contract itself. The duty of a court is to examine every part of the agreement, every stipulation which it contains, and to consider their mutual bearing upon each other; but it is entirely beyond the function of a court to disregard the plain meaning of any term in the agreement unless there can be found within its four corners other language and other stipulations which necessarily deprive such term of its primary significance."

And at page 468, Lord Watson concluded:-

"If there had been in the deed language which shewed that the parties were using those expressions inadvertently, or that they had entered into other stipulations which were in substance contrary to the expressed intention, the case would have been otherwise."

67. In Lloyds & Scottish Finance Limited v Cyril Lord Carpets Sales Limited & Ors. [1992] BCLC 609, the House of Lords considered, in the course of a wider appeal, an argument that block discounting of trade debts was in effect the lending of money. As to this, Lord Wilberforce said, at page 615:-

"Secondly, it has to be appreciated that block discounting is essentially a method of providing finance. Commercially and in its economic result, it may not differ from lending money at interest: the 'discounting charge', which represents the finance house's profit, is stated in terms of so much per cent per annum, which percentage is no doubt based upon current interest rates. Legally, however, there is no doubt that discounting is not treated as the lending of money and that the asset discounted is not the subject of a charge."

Lord Wilberforce then cited the passage from Lord Devlin's speech in Chow Yoong Hong at page 216, which appears above, and continued:-

"Equally clearly a discount charge is a different thing from a payment of interest."

In distinguishing a loan from a sale, Lord Wilberforce concluded (at page 617):-

"My Lords, the fact that the transaction consisted essentially in the provision of finance, and the similarity in result between a loan and a sale, to all of which I have drawn attention, gives to the appellants' arguments an undoubted force. It is only possible, in fact, to decide whether they are correct by paying close regard to what the precise contractual arrangements between them and the respondents were. Given that the trading agreement was a real contract, intended to govern the individual transactions which followed and (as is accepted) that it was not rescinded or varied, the ultimate question must be whether what was done can be fitted into the contractual framework which that agreement set up with such reasonable adaptations as should be needed in commercial practice and as should not transfigure the nature of the contract."

68. In Marren v Ingles (1980) 54 TC 76, the House of Lords construed the term "debt" in paragraph 11 of Schedule 7 to the Finance Act 1965 in the context of an assessment to capital gains tax on "half the profit" to be made on a future and uncertain sale which, in the event, took place. Paragraph 11 was described by Lord Wilberforce (at page 96) as "a provision of notable obscurity, the purpose and philosophy of which it is difficult to detect." Lord Wilberforce went on to say:-

"No case was cited, and I should be surprised if one could be found, in which a contingent right (which might never be realised) to receive an unascertainable amount of money at an unknown date has been considered to be a debt - and no meaning, however untechnical, of that word could, to my satisfaction, include such a right."

Lord Fraser's opinion was likewise that a payment obligation which was (a) possible rather than definite, (b) unidentifiable in amount, and (c) payable at an unascertainable date, was not a 'debt' (at page 100).

69. Our attention was also drawn to West Deutsche Landesbank Girozentrale v Islington London Borough Council [1966] AC 669, in which Lord Goff, in the context of the well-known litigation about interest rate swaps, observed of the swap transactions (at page 680):

"The practical effect is to achieve a form of borrowing by, in this example, the floating rate payer through the medium of the interest rate swap transaction."

The significance for this appeal is said to be that the swap transactions, though designed to avoid restrictions on borrowing by local authorities, were not in law classified as the loans which they replaced.

70. Of less assistance is Webb v Stanton (1883) 11 QBD 518, where the Court of Appeal was interpreting Order XLV., rule 2, relating to garnishee orders, under which such an order might be obtained where a debt was "owing or

accruing". The case is relied on for the statement by Brett M.R. at page 524 about debts:-

"There again it is obvious that in 1875 that learned judge [Blackburn J.] construed the words 'accruing debt' to mean a debt debitum in presenti, solvendum in futuro. Now that is a debt known to the law and which the law has always recognised. The law has always recognised as a debt two kinds of debt, a debt payable at the time, and a debt payable in the future, and unless the legislature intended to invent a new kind of debt not known to the law, 'accruing debt' can only be what the judges have so stated."

71. It emerges clearly, therefore, that the mere economic equivalence of a transaction to a loan does not show that it is a loan. The authorities show, equally - as Chitty comments - that the concept of "loan" or "lending" may vary from statute to statute if a particular meaning is adopted. In the case of Chapter II of Part IV of the 1996 Finance Act, the concept of a "loan relationship" is certainly unique to this statute but it does not appear that the underlying notion of the lending of money is to be seen in any way differently from that in which it would be seen generally. The contrary is the case: by specifically referring to the concept of "a transaction for the lending of money", section 81(1)(b) evidently intends to confine a concept whose extent may otherwise be uncertain within well-known and ascertainable bounds.

72. None of the many witnesses we heard, despite very thorough cross-examination, was prepared to recognise any of the derivatives purchase transactions as loans, whether or not they were assorted with put or call options or two-way compensation agreements. Dr Golden's expert evidence was that although the collateral arrangements (the deposits back of the prices already paid) were important from a commercial perspective, their importance was secondary in relation to the issue of whether the transactional documentation was appropriate for loan transactions. (We note that there is no tax issue arising in connection with the deposits themselves, and that it is agreed that they were made to satisfy regulatory requirements.) Having exhaustively reviewed all the transactions under appeal, Dr Golden concluded that all of them were structured on a substantially similar basis and said that:-

"In my opinion, the documentation used for the index-linked transactions would not be used, and would not be suitable to be used, for loan transactions, even though the cash flows or the economic effect of a given loan and a particular derivatives transaction may turn out to be similar."

73. In our judgment, it is impossible to conclude that any of the parties to these transactions thought that they were

lenders or borrowers, or that they intended that to be the case. They plainly intended to enter into the legal relationships which the documentation showed that they established, and indeed they took care to enter the relationship of buyer and seller of financial futures and not that of lender and borrower. The fact that, in doing so, they were clearly anxious to fall within one tax regime rather than another is beside the point. We consider below whether there are grounds for adopting the Ramsay approach to the facts of this case, and whether it would make any difference to the result; but as a matter of general principle, the circumstance that parties conducting business in a highly complex and technical field rely on professional advice about the tax consequences of the way they transact their business, and shape it accordingly, has in itself no bearing upon the analysis of what they have done.

(iii) Do the transactions, if not loans, constitute "any advance of money" within the meaning of section 103?

74. The meaning of the expression "any advance of money" in section 103 is left undefined and there is, as with the concept of lending, some initial degree of uncertainty attached to it. In the context in which it is used, the phrase could be expected to refer to something in the nature of a loan or something ancillary to a loan, and not to extend beyond the broad confines of that concept; any other and wider interpretation risks introducing, by way of an including provision, concepts which go beyond the scope of the lending relationship at the centre of Chapter II of Part IV. We are thus disposed to take the expression as referring only to payments made in connection with loans or on account of them. Examination of such authorities as bear on the term 'advance', though each one turns on its particular facts, tends to support that conclusion.

75. The first, Smart v Lincolnshire Sugar Co Limited (1936) 20 TC 643, was on peculiar facts concerning subsidies paid to the manufacturers of sugar from sugar beet pursuant to Acts of Parliament designed to support the industry in question. The statutes provided for "advances" to be made to certain companies in respect of sugar manufactured by them, subject to conditions, for the purpose of enabling the companies to buy home-grown sugar beet; and for "the recovery in certain events of the whole or some part of the advances so made, and for the remission of any balance not so recovered" (emphasis supplied). The main dispute was whether the payments provided for by the statute were really subsidies or payments which fell within the general principles on subsidies, or whether they were loans.

76. In the House of Lords, Lord Macmillan, giving the leading speech, held that the advances were in law trading receipts; he said (at page 670):-

"I agree that the word 'advances' is ambiguous and may either refer to prepayments of what will become due in future or be a polite euphemism for loans; but when 'advances' are declared to be 'repayable' (though only conditionally) they certainly lean to the side of loans.

But in my view the question ought not to be decided on merely verbal arguments. What to my mind is decisive is that these payments were made to the company in order that the money might be used in their business."

77. The second case is Burnes v Trade Credits Limited [1981] 1 WLR 805. This was a decision of the Privy Council on the interpretation of a guarantee for "any advance or further advances". It was held that "advance" did not cover an extension of time for the repayment of the amount lent. In a brief judgment, Lord Keith expressed the view of the Board (at page 808) that:-

"While the meaning of the word 'advance' may be shaded somewhat by the context, it normally means the furnishing of money for some specified purpose. The furnishing need not necessarily be by way of loan, but clearly that was what was in contemplation here."

78. Finally, in Bronester v Priddle [1961] 1 WLR 1294, the question turned on the rights of the parties under a contract in pursuance of which a salesman, remunerated by commission on his sales at the point at which they were paid for, was given advances of up to half that commission upon the orders merely being taken. On his resignation, advances of commission made to him were outstanding and it was held by the Court of Appeal that he was obliged to repay them. Holroyd Pearce L.J. approved the reasoning of the judgment under appeal as follows:-

"It seems to me that 'advance' means: 'I will pay now what I may have to pay in the future. I am paying before due time. If, after the advance, some event in the future upon which payment becomes due does not occur, you (sic) can recover it back.' There are to be found cases where a tenant has paid rent in advance before due time to the landlord. That was held to be a loan by the tenant to the landlord. It was not rent because it was not due; it was in the nature of a loan. When someone says: 'I am going to make you an advance,' I think they are saying: 'We will let you have it as a loan or on an implied understanding that if the event does not occur which makes it legally payable, we must have it back."

79. Effectively, "advance" adds nothing in the present context. The price paid for the financial future in each case was paid at the point at which it was bought, that is to say at the start of each fasiculus of transactions. It was not a payment in advance for the sum due to the Life Office on maturity, but a payment for rights which existed

immediately upon payment. This may be seen clearly enough in the cases of partial surrenders of individual policies where bondholders died before maturity, and the consequent acceleration of the corresponding part of the Life Office's derivative contract.

(iv) Are the transactions properly the subject of a Ramsay analysis?

80. An alternative ground of argument advanced by the Crown is that "the concept of a debt which falls to be settled by a payment of money and the loan relationship legislation as a whole is clearly a commercial concept and should accordingly be construed as referring to the business substance of the transaction" (paragraph 35 of skeleton argument). Thus, it is argued that in commercial terms it was always the parties' expectation and intention that the final settlement of the bargains would be in cash, and that the primary obligation to settle in shares had no business purpose: it is said that that primary obligation was not a sham, but should nonetheless be ignored as a consequence of giving a commercial construction to the relevant fiscal concept.

81. This argument must rely principally for support on the most recent authority on the Ramsay approach to statutory construction, which is the decision of the House of Lords in Macniven (Inspector of Taxes) v. Westmoreland Investments Limited [2001] 2 WLR 377; [2001] STC 237. There, their Lordships adopted the following conclusions:-

(i) the Ramsay principle is one of statutory construction and is designed to ascertain whether Parliament intended the statutory language used in fiscal legislation to have (a) a juristic or legal meaning only, or (b) a commercial meaning capable of transcending the juristic individuality of the various parts of a preplanned series of transactions;

(ii) if (i)(a) is appropriate, it makes no difference whether the transaction has a business purpose because such a purpose is not part of the relevant concept;

(iii) if (i)(b) is appropriate, steps which have no commercial purpose but which are artificially inserted for a tax purpose into a composite transaction are to be disregarded in applying the relevant statutory language;

(iv) the disregarded steps are, however, not treated as if they had never occurred, even for tax purposes.

82. The approach is thus concerned with the construction of

the words of the statute. But how is it to be determined whether the statutory language under consideration falls within (i)(a) or (i)(b)? This depends on the particular expressions in their context.

At paragraph [6], Lord Nicholls observed:-

"[6] When searching for the meaning with which Parliament has used the statutory language in question, courts have regard to the underlying purpose that the statutory language is seeking to achieve. Likewise, Lord Cooke of Thorndon regarded Ramsay as an application to taxing Acts of the general approach to statutory interpretation whereby, in determining the natural meaning of particular expressions in their context, weight is given to the purpose and spirit of the legislation (see IRC v McGuckian [1997] STC 908 at 920)."

And at paragraph [8]:-

[8] 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.

Lord Hoffmann's formulation (at paragraph [29]), was:-

"There is ultimately only one principle of construction, namely to ascertain what Parliament meant by using the language of the statute."

At paragraph [41] Lord Hoffmann made these observation on Ramsay,

"Thus in saying that the transactions in Ramsay were not sham transactions, one is accepting the juristic categorisation of the transactions as individual and discrete and saying that each of them involved no pretence. They were intended to do precisely what they purported to do. They had a legal reality. But in saying that they did not constitute a 'real' disposal giving rise to a 'real' loss, one is rejecting the juristic categorisation as not being necessarily determinative for the purposes of the statutory concepts of 'disposal' and 'loss' as properly interpreted. The contrast here is with a commercial meaning of these concepts. And in saying that the income tax legislation was intended to operate 'in the real world', one is again referring to the commercial context which should influence the construction of the concepts used by Parliament."

Lord Hoffmann said this at paragraph [49]:-

". 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."

He identified the relevant concept in Macniven as that of payment, the crucial expression being "paid" in section 338 of the 1988 Act.

Lord Hope, at paragraph [76], and Lord Hobhouse at paragraph [98], concurred with Lord Hoffmann. Throughout, their Lordships concentrated on the meaning of "paid" and "payments" in the statute, albeit in the context of section 338..

83. Of the other authorities which bear on the applicability of the Ramsay approach, IRC v Wesleyan and General Assurance Society and Griffin v Citibank Investments Limited were decided before the House of Lords' judgments in Macniven were reported; only DTE Financial Services Limited v Wilson was decided afterwards and, in that case alone, the decision in Macniven was considered when the appeal was heard.

84. In DTE, reported at [2001] STC 777, the Court of Appeal applied the Ramsay approach to a tax avoidance scheme designed to avoid liability for national insurance contributions and to enable an employer to make payments to employees outside the PAYE system. The scheme involved the payment of bonuses to employees by means of a contingent reversionary interest under a settlement which, virtually at once, turned into cash, as indeed the parties had always intended. The question in that appeal was whether a "payment" had been made for the purposes of section 203 of the Income and Corporation Taxes Act 1988 and the PAYE regulations made under it.

85. Having heard submissions on the effect of the Macniven restatement of the Ramsay approach, Sedley LJ, giving the leading judgment, said (at paragraphs [42] and [43]):-

"[42] So far as the Ramsay issue is concerned, therefore, the only question (to my mind) is whether it is legitimate to apply the Ramsay principle - or, if one prefers, adopt a Ramsay approach - to the concept of 'payment' in the context of the statutory provisions relating to PAYE. In my judgment it plainly is. I accept Mr Glick's submission [for the Crown] that in the context of the PAYE system the concept of payment is a practical, commercial concept. In some statutory contexts the concept of payment may (as Lord Hoffmann pointed out in Macniven) include the discharge of the employer's obligation to the employee, but for the purposes of the PAYE system payment in my judgment ordinarily means actual payment: i.e. a transfer of cash or its equivalent."

"[43] Nor can I accept Mr Thornhill's submission [for the taxpayer] that to apply the Ramsay principle to the PAYE system will inevitably introduce confusion and uncertainty into the statutory code. The true position, as I see it, is that for those employers who operate the PAYE system in a straightforward manner, and who do not resort to the complexities of tax avoidance schemes, there will be neither confusion nor uncertainty; whereas for those employers who choose to operate such schemes the effect of applying the Ramsay principle is to restore the certainty which the legislature intended."

86. In DTE, the scheme in question was unquestionably artificial and circular, and it is not difficult to see why it failed at all three levels of appeal. In the present case, it has been argued for the Revenue that, albeit with a very much longer timescale, the same is true, that the derivatives purchased, the deposits made against the payments from the Life Offices, and the options attached to the purchases, were all part of an elaborate smokescreen to divert attention from the fact that £x was being paid initially for a (in practice certain) return of £x+y at term for what was really occurring was no more than simple deposit of money on terms only slightly different from those found in traditional moneylending transactions, the bankers having the customary opportunity to trade profitably with the money in the meantime.

87. It is therefore necessary first to identify the statutory expression or expressions to which it is sought to apply Ramsay. Mr Henderson identified the phrase "money debt" defined in section 81 as "a debt which falls to be settled by a payment of money" and contended that the provisions for settlement otherwise than in cash should be ignored. The crucial words in section 81(2)(a) are "a debt which falls to be settled". We do not find it easy to regard the words "falls to be settled" as used other than in a juristic sense: it would have been quite simple for the draftsman to use less precise wording. However in any event there can be no loan relationship within section 81(1) unless the debt arises from a transaction for the "lending of money" within section 81(1)(b).

88. The issue must, therefore, focus primarily on section 81(1)(b): does the phrase "lending of money" have a narrow juristic sense, or is it used in a commercial sense to mean whatever the informed businessman would regard as the lending of money? We are not persuaded that the expression "lending of money" is used in a wide commercial sense going beyond its juristic or legal sense. However in fact, our conclusion is that here it makes no difference in which sense the statutory phrase is interpreted. If it is in the juristic sense, it is clear that mere economic equivalence does not suffice to turn a transaction which is not a lending of money into a transaction which is one. If the commercial sense is intended, we have had no evidence which would justify a finding that those in commerce would regard the transactions in question viewed as a whole as

involving the lending of money; as we have noted, all the evidence has, indeed, been to the contrary.

89. It follows from this that the attempt to apply the Ramsay approach falls at the first hurdle. And it must be borne in mind that there is no indication that the loan relationship legislation was intended as an anti-avoidance measure, and that one must look for a mischief intended to be remedied. There is no sign either that this important new regime is designed to be at odds with the expectations and realities of the financial world as they have been described in the evidence before us. It is plainly a world of much sophistication and complexity, in which transactions are not conceived or concluded without specialist legal advice about their form and content. That circumstance is not, in itself, any reason for regarding them as artificial or uncommercial: to do so would be to mistake the character of the financial instruments at issue and the financial markets in which they are used. The decided cases give no support to the application of the Ramsay approach by reference to the scheme of the legislation on loan relationships as a whole without the need to identify first the particular expressions to which it is said to apply.

(v) Is the letter from Dr Williams of the Inland Revenue to KPMG a relevant or admissible aid to construction of the loan relationship legislation?

90. In Bibby v Prudential Assurance Company Limited [2000] STC 459, Sir Richard Scott V-C. took into account in construing section 95 of the Taxes Act 1988 (previously section 54 of the Finance Act 1982) both Treasury and Inland Revenue explanatory press releases in March 1982 when the provision had been announced, and clearly regarded them as relevant aids to interpretation (see paragraphs 61, 62 and 68 of the judgment). The Vice-Chancellor takes it as self-evident that these materials are admissible as aids to construction and does not discuss the reasons for admitting them or the circumstances in which they should be relied on. No other authority on that was cited to us.

91. Mr Aaronson says that we should do likewise in this

case with Dr Williams's letter and, indeed, with the Revenue's internal Life Assurance Manual. Mr Henderson submits that the letter and the manual, at most, show a particular opinion held within the Revenue as to the meaning of the legislation and an inclination to apply it accordingly and cautions against straying into matters properly considered, if at all, on judicial review; so far as statutory construction is concerned, he says that these two sources can contribute nothing to the exercise.

92. It is certainly the case that, in so far as Abbey Life, as Dr Green said in his evidence, relied on this letter to its detriment their remedy must lie, if at all, on judicial review; and that is not disputed. As to is relevance in interpreting the statute, we have no hesitation in concluding that it is of no help.

93. Firstly, it is apparently written after the enactment of the legislation in question, and is not therefore evidence of what was intended in the Bill put before Parliament. Second, there was no reference to Life Offices, generically or by name. Third, it was stated to refer to companies investing on non-trade account, whereas Life Offices carry on the trade of life assurance and would arguably be so acting. Fourth, the letter was not a public statement of what proposed legislation was designed to do; it was a private statement if what, in the most general terms, the Revenue thought that it did do.

94. In so far as it is appropriate at all to take it into account, the same comments apply to the Revenue's Life Assurance Manual, which was no more intended for general consumption than the letter: if that is wrong, and the Manual does give rise potentially to a legitimate expectation, that is not a matter for us; it is clearly not evidence of what Parliament would have intended in passing the legislation.

(vi) Is section 128 of the Taxes Act 1988 applicable?

95. In view of the conclusions reached so far, it is unnecessary to consider whether section 128 withdraws transactions otherwise within the scope of the loan relationship provisions from them, but full argument was addressed on this point and we therefore set out our conclusions on it.

96. The reference in the section to "dealing" must refer to transactions carried out by way of business in the broadest sense, and not necessarily by a person who is "dealer" in financial futures or options as such, in order to be understood consistently with the phrase "otherwise than as the profits of a trade" in the section. In this case, the transactions in question were undoubtedly carried out by the appellants by way of business and their profits from them therefore fall within the scope of the words "any gain

arising to a person in the course of dealing in . financial futures."

97. But would they, section 128 apart, be "chargeable to tax under Schedule D otherwise than as the profits of a trade"? It is common ground that the Life Offices are carrying on a trade, and are authorised persons or listed institutions: the issue between the parties is whether the revenue from that trade is taxable as the profits of a trade, or as something else. The something else, according to Mr Aaronson's argument, is the I minus E basis, which now has a statutory basis but which has, he says, been consistently used by the Revenue since 1915 to tax the profits of Life Offices. This method consists of taxing as profits the excess of income over expenditure and is, given the difficulty of using any other method to determine Life Offices' profits because of the need to establish their future liabilities, the only one easily practicable.

98. Mr Aaronson submits that the I minus E basis must be contrasted with taxation under Case I of Schedule D, and that it is only the latter which is contemplated by the words "chargeable to tax ... as the profits of a trade". The reply to that is that section 143(3) of the 1992 Act, which introduces a deemed dealing in financial futures, indicates, by using the phrase "arises in the course of a trade", that the trade source of the receipt is what is important rather than the particular head of charge under which a given trading receipt is taxed; in other words, what are excluded from capital gains tax treatment are trading transactions as such, and not trading transactions which are taxed under Case I.

99. The effect of sections 128 and 143, in our view, to extend the meaning of dealing in financial futures contracts beyond the cases of those dealing on the recognised futures exchanges to those who purchase such contracts "over the counter", that is to say, otherwise than by dealing on the appropriate exchange; and to provide that where the dealing, or deemed dealing, is not by way of trade it is subject to capital gains tax.

100. In this instance, the transactions described above were not, within the meaning of section 143(2)(a) and (3)(a), "financial futures which are for the time being dealt with on a recognised futures exchange": the financial futures in this case were, according to the evidence, invariably paid for at the outset, whereas Dr Golden's evidence was that a typical or common feature of financial futures dealt with in the markets was that one party would pay the other the difference between the contract price for the future and the market price of the underlying assets when the contract matured.

101. In Manufacturers' Life Assurance Co v Cummins [2001] STC 316, the court had, in essence, to construe

words contained in a prospectus issued by the Treasury under section 47 of the Taxes Act 1988 for government securities on which interest due to non-residents would be exempt from tax. The provision in question was as follows:-

"... these exemptions will not apply so as to exclude the interest from any computation for taxation purposes of the profits of any trade or business carried on in the United Kingdom."

102. It had been argued for the taxpayer that the I minus E basis did not produce "profits", whereas a computation in accordance with Schedule D case I did produce "profits". Noting that it was not open to the Revenue to tax a mutual company (the taxpayer in that case) under Case I, the special commissioner commented that it was open to the Revenue so to tax a proprietary insurance company instead of using the I minus E basis of computation. On appeal, Neuberger J. cited the explanation given by Robert Walker J. in Johnson v Prudential Assurance Company Limited 70 TC 445, at 464, that:-

"Every life assurance company carries on a trade the profits of which are taxable under Case I of Schedule D but the specialised nature of the trade has over a century or more led to special rules being introduced and refined, sometimes by direct and positive enactment and sometimes by statutory recognition of principles established by case law or by practice. The most striking illustration of established practice being recognised by statute is perhaps the definition in section 65(3)(a) of the Finance (No 2) Act 1992 of 'the I minus E basis [as] the basis commonly so called'".

103. In Johnson v Prudential Assurance Company, Robert Walker J. had noted (at page 464), citing earlier authority, that the investment income of a life assurance company is a trading receipt, and (at page 465) that such a company would have no relevant business which was not a trade whose profits were taxable under Schedule D, Case I. Affirming the decision on appeal, Nourse L.J. said (at page 474) that "The business of a life assurance company is a trade taxable under Case I of Schedule D. ... Alternatively, the Crown may choose to tax the company on the I-E basis, there being excluded from 'E' in this case expenses other than those of management. The actuarial measure of the liability of the trade is also excluded."

104. Moreover, there is the comment of Lord Radcliffe in Ostime v Australian Mutual Provident Society [1960] AC 459, at 478-9, that the I minus E basis produces "given the allowance to the company of its management expenses, an adequate, though never an accurate, measure of the annual profit accruing to the business", in which Lord Radcliffe was accepting that this was a rough and ready way of measuring the profits of a business, albeit not by

means of a Case I computation.

105. In Manufacturers' Life, Neuberger J. also accepted (at page 329a) that the application to a Life Assurance Company of the I minus E basis involved the computation for tax purposes of the profits of its trade or business, and (at page 329f) that I minus E is a method of computing the income or gains of a business. It is true that, as a second reason for his decision, the learned judge indicated that any other conclusion in the context would produce anomalous results.

106. Taxation on the I minus E basis is taxation under Schedule D, it is in respect of profits or gains and they are taxable as profits of the trade, see Johnson. The fact that they are taxed under a Case other than Case I does not affect their character of profits of a trade.

107. This is not a question of the extent of a taxing statute, but of which of two broad bands of taxation receipts fall under, and there is no presumption either way as to the outcome to be sought. For the reasons indicated, we therefore conclude that the transactions in this appeal were not within section 128 of the Taxes Act 1988.

108. Finally, if it is necessary to express a view on it, we accept Mr Henderson's argument that section 80(5) of the 1996 Act is designed to make it clear that there can be no double counting in the charge to tax in relation to cases already within the scope of the loan relationship provisions. It is not intended to mean that matters not with the loan relationship provisions are not subject to any charge at all to corporation tax.

Summary

109. We summarise our conclusions.

(i) Apart from those transactions which under their terms were to be settled in cash (whether or not with an option for settlement in shares), the transactions did not create "money debts" within section 81(2) and therefore section 81(1)(a). The question whether a debt "falls to be settled" by a payment of money depends on the legal relations giving rise to the debt (paragraphs 47 to 54).

(ii) Under section 81(1) those transactions giving rise to "money debts" within section 81(2) did not give rise to a loan relationship unless "arising from a transaction for the lending of money". This involves a borrower and a lender and also a loan. From any commercial perspective none of the transactions involved loans. None of the parties regarded themselves as lenders or borrowers or intended to be. Apart from any possible application of the Ramsay approach, none of the debts arose from a transaction for the "lending of money" (paragraphs 55 to 73).

(iii) None of the transactions involved an "advance of money" within section 103 (paragraphs 74 to 79).

(iv) The Ramsay approach depends on identifying words or phrases in the statute which impart commercial concepts going beyond their juristic meaning. Neither "falling to be settled" nor "lending of money" is such a concept. Furthermore even viewed as a totality, the transactions did not involve "lending of money" (paragraphs 80 to 89).

(v) Neither the letter to KPMG nor the Revenue's Life Assurance manual is an admissible aid to the construction of the legislation (paragraphs 90 to 94).

(vi) The Transactions were not within section 128 of the Taxes Act 1988 (paragraphs 95 to 107).

Decision

110. These appeals are, accordingly, successful. The parties are at liberty to apply for specific determinations of the underlying assessments. Since the issues have been fully argued by leading counsel, we would be minded to certify the matter as suitable for appeal direct to the Court of Appeal.

MALACHY CORNWELL-KELLY

THEODORE WALLACE

SPECIAL COMMISSIONERS

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