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By: Pete Miller
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Trigg case and qualifying corporate bonds

Conversion clause

KEY POINTS

- Partnership bought undervalued bonds, sold them and claimed exemption from capital gains tax under TCGA 1992, s 115.
- Effect of foreign currency conversion on qualifying corporate bonds.
- Court of Appeal said the bonds did not contain provisions for their conversion as in TCGA 1992, s 117(1)(b).
- Case concerned only euro-conversion clauses in bonds.

Nicholas Trigg was a member of Tonnant LLP, a partnership that bought some undervalued bonds and later sold them at a profit. He argued that these were qualifying corporate bonds (QCBs) and, therefore, exempt from capital gains tax (TCGA 1992, s 115). HMRC said the bonds were not QCBs (non-QCBs) so capital gains tax was due. The bonds concerned each had one of two schedules that were intended to activate if the UK joined the eurozone. Schedule A provided for conversion into any other currency that became the legal tender of the UK; schedule B specifically said the bonds would convert to euros if the UK joined the eurozone.

The relevant point is that a bond is a non-QCB if it can be converted into or redeemed in a currency other than sterling (s 117(1)(b)). However, this does not apply if the foreign currency conversion is at the exchange rate prevailing at the date of redemption so that there is no exchange risk during the currency of the bond (s 117(2)(b)).

First round to the taxpayer

On appeal, the First-tier Tribunal (TC4079)found for Mr Trigg. The judge said, if the UK joined the eurozone, there would be a general conversion to the euro at a set rate. Therefore, a conversion into euro-denominated bonds during the lifetime of the bonds would be exactly the same, economically, as a conversion at the rate prevailing on the date of redemption.

The basis for the decision was that parliament cannot have intended there to be a difference between the two scenarios, so the purposive interpretation of s 117(2)(b) was that it should also apply to a conversion to euros at a rate that was fixed once and for all.

Therefore, the bonds were QCBs, not non-QCBs.

Next round to HMRC

The Upper Tribunal disagreed with the First-tier Tribunal and found for HMRC ([2016] STC 1310) – (tinyurl.com/yclcfy9h). The judge said s 117(1)(b) required the bond to contain no provisions for conversion into or redemption in a currency other than sterling, whereas s 117(2)(b) referred only to redemption. Since s 117(2)(b) did not refer to conversions, the tribunal said it could not be construed purposively to include them. The First-tier Tribunal's decision was incorrect, even when the conversion would give an identical economic result.

The Upper Tribunal also concluded that the word 'sterling' in the phrase 'other than sterling' denoted pounds sterling, the lawful currency of the UK. It did not mean whatever happened to be the lawful currency of the UK at the moment. As the judge said, 'no amount of purposive construction can result in sterling being given any different meaning'.

It then considered whether the schedules in the bonds were provisions, whether they were provisions for conversion and whether they were provisions for conversion into a currency other than sterling. It concluded that the schedules in the loan notes were provisions. They provided for something to happen, the mechanisms under EU law would amount to a conversion, and this would be a conversion into a currency other than sterling.

In the context of purposive construction, the Upper Tribunal found that a QCB was a 'purely statutory construct' defined by the legislative definition, which must be found in the words of the statute.

The outcome in this case was 'neither illogical nor absurd' and purposive construction did not allow a tribunal 'to fill any perceived gap, or to seek to equate cases on one side of the dividing line with similar cases falling on the other side by reason of similarity in effect on economic equivalence'.

On to the Court of Appeal

Counsel for Mr Trigg told the Court of Appeal that the original legislation had been intended to encourage investment in sterling-based securities such as gilts and loan stock, so that the exception was intended to bring into capital gains any bonds that were capable of generating foreign exchange profits, which ought to be taxable. Since that was the purpose of the legislation, it should be construed in this light when viewing the commercial reality of the bonds in question.

The court's decision was given by Lord Justice Patten, with Lord Justice Floyd and Lord Justice Hamblen agreeing. The judge's summary of the arguments for Mr Trigg was:

- the word 'provision' in s 117(1)(b) could be read as applying only to provisions for conversion into or redemption in a foreign currency that is co-existent with sterling and gives rise to the possibility of foreign exchange and similar gains;
- one can read the reference to 'a currency other than sterling' as restricted to a foreign currency other than sterling or whatever replaces sterling as the national currency from time to time; or
- one can read 'sterling' as meaning sterling or whatever replaces it as the unit of national currency.

The court considered each of the three possibilities before applying the purposive approach which was, in essence, that the bonds did not contain provisions for conversion of the bonds in the way contemplated by s 117(1)(b).

Meaning of 'sterling'

Taking the final point first, the Court of Appeal agreed with both previous tribunals. The judge noted, for example, that there was no legislative qualification of the word 'sterling'. Given the original tax exemption for sterling bonds was intended to boost the British bond market, it was clear that previously issued eurobonds would not automatically become exempt were the UK to adopt the euro as its currency. Any change in the currency of the UK would require amending legislation if parliament decided that that the exemption should continue to apply to eurobonds in the same way as it had previously to sterling bonds.

Currency other than sterling

The judge noted that the First-tier Tribunal's interpretation of the phrase 'a currency other than sterling' was not brought up. However, he agreed with HMRC that the disparity between s 117(1)(b) – which refers to provision for conversion or redemption – and s 117(2)(b) – which refers only to redemption – must be intentional. He agreed with the Upper Tribunal that the effect of the legislation 'is to treat redemption of sterling bonds in a different currency as equivalent to redemption in sterling [only] where the rate of exchange is the one prevailing at redemption'. This exception did not need an extended meaning and was 'effective on its own terms'.

Counsel's argument for Mr Trigg was that the exception in s 117(2)(b) should be treated purposively 'as confirmation of the intention of the legislature to exclude bonds with provisions for conversion into and redemption in another currency only where that gives rise to the possibility of forex and other gains'. The judge accepted that s 117(2)(b) gave some guidance as to the meaning of the phrase 'redemption in a currency other than sterling'. But he said it also confirmed that parliament had intended the words of s 117(1)(b) to bear their ordinary meaning, apart from that one exception, so that s 117 could not be given the purposive meaning argued for by Mr Trigg.

The judge also reminded us that the word 'sterling' must be taken as meaning exactly that, as already discussed.

Taking these points into account, the single question was whether the schedules to the bonds should be treated as the kind of provision for conversion into a different currency which was intended by parliament.

Provision for conversion

The emphasis here was on the word 'conversion'. The judge chose to interpret this in the context of the EU directives that would operate were the UK to adopt the euro. In particular, the judge quoted Art 2 of Council Regulation (EC) No 974/98, as amended by EC No 2169/2005, which states:

'With effect from the respective euro adoption date, the currency of the participating member states shall be the euro.'

The Upper Tribunal had decided that the adoption of the euro would not necessarily mean that the bonds were immediately redenominated into euros. This was on the basis of a transitional period in the regulations to allow for the introduction of euro banknotes and coins and to phase out use of the old notes and coins of the participating member states, and because there was no guarantee that the UK would enter the euro under the same terms as these regulations.

The Court of Appeal disagreed. It said the schedules (in the bonds) would necessarily be triggered on the basis that the UK had waived its derogation from the regulations. This must imply that the UK would then 'adopt monetary union in accordance with the treaty', and, therefore, in accordance with those regulations.

Further, the regulations made it clear that existing currencies were treated as sub-divisions of the euro during the transitional period, not as separate currencies. The judge went on to say that the precise legislative machinery by which the euro is adopted is not relevant although, if one were to be looking at a legislative mechanism, one could look only at the mechanism that would prima facie apply, namely the existing EU regulations.

Although the judge did not explicitly explain this, he appeared to take the view that, had the UK joined the eurozone and the bonds were redenominated into euros, it would not amount to a conversion, as such.

He thus concluded:

'I consider that the bonds are QCBs notwithstanding the inclusion in them of the schedule A or schedule B provisions.'

The schedules could not be provisions made for conversion if the mechanism whereby the bonds became eurobonds was not actually a conversion.

Practical significance

The significance to practitioners is the fact that similar clauses may have been used to ensure that bonds issued on, say, the sale of a company are not corporate bonds because it is generally beneficial to receive non-QCBs rather than QCBs in such transactions. This decision may mean that some clients hold QCBs that they thought were non-QCBs. If this applies to readers' clients, it may be helpful to identify the issue right away.

The decision applies only to euro conversion clauses, because the rationale was based on the replacement of UK sterling by another currency. So if you have used, say, US dollars in your loan notes, you should be safe from challenge. What is not clear is whether conversion clauses referring to euros, but not the adoption of the euro as the UK's currency, will continue to be effective to prevent a bond being a corporate bond. I believe they would because those conversion clauses envisage the possibility of operating at a time when sterling also continues to exist, so that there is clearly provision for an actual conversion and this would be into a currency other than sterling.

It might also be prudent in future to ensure that a loan note is not a QCB by virtue of not being a 'normal commercial loan', as defined in CTA 2010, s 162.

HMRC may appeal against this decision to the Supreme Court, although nothing has been heard yet, so it is possible that the arguments will be reconsidered. If not, the Court of Appeal's decision sets a precedent.

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