Appeal number: FTC/64/2013

INCOME TAX — floating rate notes stripped of intermediate interest coupons — whether difference between purchase price when coupons stripped and sale price when remaining coupons to redemption re-attached a capital or income gain — income — whether a "discount" within Schedule D Case III — yes — appeal dismissed

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

MALCOLM HEALEY **Appellant**

- and –

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

Tribunal: Hon Mr Justice Henderson
Judge Colin Bishopp

Sitting in public in London on 27 and 28 October 2014

Mr Kevin Prosser QC and Mr Charles Bradley, counsel, instructed by Hotham Services Ltd, for the Appellant

Mr Michael Gibbon QC and Mr Imran Afzal, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

Mr Justice Henderson and Judge Bishopp:

Introduction

1. The sole issue in this appeal is whether the taxpayer, Mr Healey, realised a profit of an income nature when on 12 September 2003 he sold in the market a floating-rate promissory note ("FRN") which he had bought on 11 December 2001 from Kleinwort Benson Private Bank ("KB"). The profit which Mr Healey realised on the sale was £2.211 million. It is now common ground that, if the profit was of an income nature, it was subject to income tax in Mr Healey's hands under Case III of Schedule D, which at the material time charged tax in respect of "all discounts". If, however, it was a profit of a capital nature, it was not liable to income tax and it was also exempt from capital gains tax ("CGT") as a gain accruing on the disposal of a qualifying corporate bond: see sections 115(1) and 117 of the Taxation of Chargeable Gains Act 1992.

2. The FRN in question ("the ANZ FRN") was a normal commercial security which had been issued at par (£30 million) by ANZ Bank. It was redeemable, also at par, on 13 September 2004, and carried interest in the meantime at a commercial floating rate linked to LIBOR, payable quarterly on 12 March, June, September and December each year until 12 September 2004, the day before redemption. ANZ Bank had a high (A or Aa) credit rating. Because of that, and the floating commercial interest rate, it was predictable that the ANZ FRN would trade at a market value close to its par value throughout its term.

3. It is therefore no surprise that the price which Mr Healey obtained for the ANZ FRN when he sold it (through KB) on 12 September 2003, immediately after payment of the interest coupon due on that day, was £29.997 million. This price reflected the rights which the purchaser acquired to receive the par value of the note on redemption a year later, together with the four remaining payments of interest which would fall due in the meantime.

4. Given the commercial nature and structure of the ANZ FRN, how did it come about that Mr Healey realised a profit of £2.211 million on its sale? The answer is that when he bought the ANZ FRN from KB on 11 December 2001, the interest coupons had been stripped from it: Mr Healey acquired the benefit of the coupon due on the next day, 12 December 2001, (coupon 1) and the four coupons due from 12 December 2003 until 12 September 2004 (coupons 9 to 12), while KB retained the benefit of the seven interest coupons falling due from 12 March 2002 until 12 September 2003 (coupons 2 to 8). Thus the price which Mr Healey paid to KB for the ANZ FRN reflected the right to receive the £30 million principal on redemption and the rights to interest conferred by coupons 1 and 9 to 12, but not the rights to receive coupons 2 to 8 which had been retained by KB.

5. As the First-tier Tribunal (Sir Stephen Oliver QC and David E Williams CTA, "the FTT") explained in paragraph 3 of their decision ("the Decision") released on 7 March 2013:

> "In essence, Mr Healey was supplied by [*KB*] with six similar products described and marketed by KB as 'Flexi-Notes'. Each Flexi-Note product contained a [*FRN*] issued by a corporate body (with an 'A' or 'Aa' credit rating) from which the interest coupons were to be stripped on the instructions of KB. The stripped coupons relating to a specified period ('the Flexi-Note Period') were retained for the benefit of KB. The remaining interest coupons were, at the end of the Flexi-Note Period, re-attached to the related FRNs (again on KB's instructions) and those FRNs were then sold on the market by KB on behalf of Mr Healey."

6. The Flexi-Note product was designed and marketed by KB as a means of providing wealthy individual UK-resident clients or their trusts with an after-tax return on their surplus cash significantly higher than the returns then obtainable on fixed-term deposits. In paragraph 16 of the Decision, the FTT quote the following extracts from the brochure provided to clients by KB:

> "… The client purchases a Flexi-Note. The underlying security of the Flexi-Note is a standard … [FRN] that has had specific coupons removed. An FRN will trade in the market at or around par (100% of the face value). The Flexi-Note however is sold to the client at a price that reflects the removal of the coupons from the security. But if a requirement arises whereby some or all of the funds invested are required in the interim, the investment may be liquidated … The goal of the Flexi-Note is to provide the investor with an enhanced after-tax return that is significantly in excess of fixed-term deposits … The after-tax return over the first 12 months is calculated to be 3.34%, which is equivalent to 5.57% before tax to a 40% taxpayer assuming a buying price on the security of 100.125%. This compares favourably with the current one year sterling deposit rate of 3.75%."

7. It was, of course, essential to the fiscal efficacy of the Flexi-Note scheme that the profit realised by the investor on sale of the FRN should not be liable to income tax. After a lengthy enquiry into Mr Healey's self-assessment tax return for 2003/4, HMRC made amendments to it in September 2011 on the footing that the profits made by Mr Healey on sale of the ANZ FRN (and other Flexi-Note products supplied to him by KB) were chargeable to income tax under Case III of Schedule D. Mr Healey appealed to the FTT, which heard his appeal in London on 12 and 14 February 2013. Counsel for Mr Healey (Mr Kevin Prosser QC and Mr Charles Bradley, who also appeared before us) argued that the profits were not "discounts" within the meaning of Case III, and that in any event they were not of an income nature. The FTT decided both issues against Mr Healey. He now accepts that the profits were "discounts", but appeals to the Upper Tribunal, with permission granted by Judge Bishopp on 8 May 2013, on the issue whether the profits were of a capital nature.

8. Whether or not Mr Healey is right in his contention, we observe that the Flexi-Note scheme could not achieve its intended object today, because Schedule 12 to the Finance Act 2013 enacted provisions which charge to income tax returns which are economically equivalent to interest as from 6 April 2013.

Facts

9. The facts are fully set out in the Decision, which is reported at [2013] SFTD 861, [2013] UKFTT 176 (TC). Oral evidence was given to the FTT by Mr A M Jones, a private banker who had been a member of the "structured products" team at KB throughout the relevant period. For the purposes of the present appeal, which is confined to questions of law, a brief summary of the salient facts will suffice. No challenge is made on *Edwards v Bairstow* grounds to any of the FTT's findings of primary fact, although one or two minor inaccuracies (upon which nothing turns) were pointed out to us during the hearing of the appeal on 27 and 28 October 2014.

10. Between December 2001 and March 2002, Mr Healey was supplied by KB with six Flexi-Note products, with an aggregate nominal value of £84.4 million. The parties agreed that one of those products, the ANZ FRN, should be taken as an example, and that the FTT's conclusions relating to it would apply to the other five.

11. We have already described the ANZ FRN in the introductory section of this decision. The only point it is necessary to add is that legal title to the FRN was at all material times held in the Euroclear system operated by Euroclear Bank SA of Belgium.

Euroclear operated both a client account and a proprietary account for KB, to which bonds or other debt instruments were allocated in accordance with KB's instructions. These could include instructions for either the stripping or the re-attachment of interest coupons. Although Euroclear's operating procedures in force at the relevant time allowed only for the detachment of coupons from fixed interest bonds, a special arrangement was made between Euroclear and KB at the design stage of the Flexi-Note product whereby Euroclear agreed to accept instructions to strip and later re-attach coupons from FRNs. However, such stripped coupons could not be traded within the Euroclear system, so they had to remain registered with KB.

12. On 6 December 2001, KB (as principal) bought the ANZ FRN in the market for a net consideration of £30,024,000, with a settlement date of 11 December 2001. At this date, the ANZ FRN carried the right to payment of the £30 million principal and 12 payments of interest, the next of which fell due on 12 December 2001.

13. Also on 6 December 2001, KB instructed Euroclear to strip all the interest coupons from the ANZ FRN with execution on 11 December 2001. On KB's instructions, the principal amount of £30 million together with coupons 1 and 9 to 12 were allocated to KB's client account, while coupons 2 to 8 were allocated to KB's proprietary account.

14. Still on the same day, KB sold its beneficial interest in the ANZ FRN to Mr Healey, with a settlement date of 11 December 2001, for a net consideration of £27,786,000. This figure was calculated by taking the price paid by KB of £30.024 million, subtracting the aggregate net present value of coupons 2 to 8 (calculated by reference to swap rates), which was £2,411,416, and then adding KB's fee of £173,416.

15. On 12 December 2001 Mr Healey received the first interest payment of £362,134.11.

16. On 5 September 2003, acting on Mr Healey's instructions, KB instructed Euroclear to re-attach coupons 9 to 12 to the ANZ FRN, for execution on 12 September 2003, so as to enable it to be sold in the market.

17. As we have already recorded, on 12 September 2003, immediately after payment of coupon 8 to KB, and acting on Mr Healey's instructions given on that date, KB as his agent sold the ANZ FRN in the market for £29,997,000 (adjusted for accrued interest).

18. Although coupons 9 to 12 had been detached from the ANZ FRN, the FTT found (in paragraph 27 of the Decision) that the expectation of all concerned with the product was that KB would duly give instructions to Euroclear to re-attach them at the end of the Flexi-Note period.

19. The total profit realised by Mr Healey on the six Flexi-Note products sold to him by KB was £8,680,000.

Legislation

20. At the material time, section 18 of the Income and Corporation Taxes Act 1988 charged tax under Schedule D as follows:

> "(1) The Schedule referred to as Schedule D is as follows-
>
> SCHEDULE D
>
> Tax under this Schedule shall be charged in respect of –
>
> (a) the annual profits or gains arising or accruing –

(i) to any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere …

(2) Tax under Schedule D shall be charged under the Cases set out in sub-section (3) below, and subject to and in accordance with the provisions of the Tax Acts applicable to those Cases respectively.

(3) The cases are –

…

Case III: tax in respect of –

(a) any interest of money …

(b) all discounts …"

21. Although section 18 did not say explicitly that the expression "all discounts" was confined to discounts of an income nature, it was common ground before us that discounts of a capital nature did not fall within its scope. It is also common ground, although the contrary has sometimes been stated in the past, that the question whether a particular receipt is of an income or capital nature is a question of law for the court to determine: see *Strick v Regent Oil Ltd* [1966] AC 295 at 313, *Beauchamp v F W Woolworth Plc* [1990] 1 AC 478 at 491, and *IRC v John Lewis Properties Plc* [2002] EWCA Civ 1869, [2003] Ch 513, at [69].

The key authorities

22. The parties agree that, although there is no case directly in point, the answer to the issue before us must be informed by, and may ultimately depend on, the principles to be derived from a handful of key authorities in which the true nature and tax treatment of discounts have been considered. We will take the cases in chronological order.

National Provident Institution v Brown (1921) 8 TC 57, [1921] 2 AC 222

23. Between 1915 and 1917, the National Provident Institution ("NPI") bought at the Bank of England certain short-dated bills issued by the Treasury. The bills carried no interest, and were issued at fixed rates of discount to their face value. The terms of the bills were between three months and a year. NPI held some of them to maturity, others were sold in the market before maturity, and some were converted into War Loan. The Revenue assessed the difference between the sums paid and received by NPI for the bills to income tax under Case III of Schedule D. The Special Commissioners upheld the assessments, and rejected NPI's contention that the sums in question represented an accretion to capital.

24. NPI's appeal to the High Court (together with an appeal by another company which raised the same issues) was dismissed by Rowlatt J. He said (at 66) that:

> "In each case one must look at the real nature of the transaction and see whether the purchase of the future obligation at a discount is really an investment of money at interest or not."

In the simple case of the purchase of a Treasury bill bearing no interest, for a discounted sum, he felt "no real doubt that the transaction is simply one of lending money at interest".

25. Rowlatt J then considered the more complicated cases where bills were not bought from the Treasury or were not held to maturity, but were either bought or sold in the market, or both bought and sold in the market. In such cases, the price depended on fluctuations in the money market, and the bill might have:

> “passed through the hands of half a dozen persons, who have made profits out of it aggregating a larger sum than the difference between the issue price and the face value, such extra profits being, of course, exactly equalled by losses made by other holders.”

The judge held (at 67) that “the difference between the amount paid on purchase and that received on realisation must be treated as a profit on the discount” within the meaning of Case III.

26. The Court of Appeal (Lord Sterndale MR, Warrington and Scrutton LJJ) unanimously agreed with Rowlatt J in relation to the simple case of bills purchased from the Treasury and held to maturity. As Warrington LJ put it at 75:

> “what the purchaser really receives at maturity is the sum he paid together with interest on that sum for the period of the currency of the bill.”

See too per Lord Sterndale at 72, and Scrutton LJ at 76-77.

27. In relation to the bills sold before maturity, however, the court held by a majority that not all of the difference between the purchase price and the sale price was taxable as a discount. Lord Sterndale MR said (at 72) that:

> “the only amount that can be taxed is the amount by which the bill has increased in value by reason of its advance towards maturity and the consequent accrual of interest upon it.”

Similarly, Scrutton LJ said (at 77) that if, in such cases, NPI were taxed on the full difference between amounts paid and amounts received, it would be wrongly taxed:

> “for it is being taxed not only on interest or discount, but on an amount increased by appreciation or accretion, or decreased by loss, of capital.”

The case was therefore remitted to the Special Commissioners for the appropriate adjustments to be made.

28. Warrington LJ dissented, saying at 75:

> “I can see no difference in principle between this [*case*] and the first. When a holder, whether the original purchaser or not, realises during currency, he really receives a proportion of the total profit resulting from the fact that the bill was bought at a discount. It is true that that proportion may not bear an exact relation to the period of currency but may be determined by variations in the value of money, in the public credit and so forth. But it seems to me that the total of the profits received by the various sellers after deducting losses, if any, cannot exceed the difference between the price originally paid and the sum payable at maturity, and that the considerations I have referred to merely affect the distribution of that difference between the various holders. Profits made by discounting bills seem to me to rest on the same footing, and conversion into War Loan also.”

29. The House of Lords unanimously agreed with Warrington LJ: see the speeches of Viscount Haldane at 83, Viscount Cave at 87, Lord Atkinson at 94-95, and Lord Sumner at 96-97. Thus, Viscount Cave said at 87:

> “The second question, which turns on the meaning of the expression ‘profits on all discounts’ contained in rule 2, presents more difficulty. The question is whether this expression includes the whole profit made by the sale of a discounted bill before maturity or only such part of that profit as is due to the advance of the bill towards maturity. Upon the whole I prefer the former view, which commended itself to Mr Justice Rowlatt and Lord Justice Warrington. The expression ‘profit on a discount’ is unusual, and (as Lord Justice Scrutton pointed out) is probably elliptical for ‘profit on a security bought at (or a transaction involving) a discount’; and if one has once embarked on such a transaction, I think that the resulting profit,

> though enhanced by adventitious circumstances, is all profit on the discount. The value of a bill in the market may vary with the rise or fall of the value of money; but there is no real accretion to capital, for the amount secured by the bill remains unaltered."

30. Similarly, Lord Atkinson said (at 94-95):

> "When one of these bills is purchased from the Treasury, all the rights it confers are purchased with it. One of those rights is that the holder of it can enforce payment of it by the Treasury at its maturity. When it is resold at an enhanced price that same right is purchased by the purchaser. The right is the same in quality and character on the occasion of both sales."

31. Since the bills were all issued by the Treasury, and since none of them carried interest, it is easy to understand why the courts in *NPI v Brown* regarded the real nature of the discount as interest payable in return for the Treasury's use of money. The more difficult point, which was only finally resolved in the House of Lords, was whether the whole of any profits made on the disposal or redemption of a bill by a secondary purchaser was also taxable. The House of Lords held that it was, because the subject-matter of the transaction was still the right to the same sum, which did not change its essential character merely because it passed through different hands. In concluding that all profits realised in the hands of secondary purchasers were taxable as income, Warrington LJ and the House of Lords were clearly influenced by the fact that the aggregate profits and losses realised by the various holders could not exceed the difference between the price originally paid and the sum receivable at maturity. The distribution of that difference between the various holders did not affect the crucial point that the nature of the discount remained the same throughout.

Jones v Leeming [1930] AC 415, (1930) 15 TC 333

32. The only relevance of this case, for present purposes, lies in a dictum in the speech of Lord Buckmaster at 419, where he said:

> "All interest is expressly taxed by the words of the Rule, and discount is in reality only interest in another form and under another name."

This dictum reflects, but takes no further, the analysis in *NPI v Brown*. It also leaves open the question whether the discount is of a capital nature. The issue in *Jones v Leeming* was whether the taxpayer, who had made a profit on an isolated transaction of purchase and resale of a rubber estate, could be assessed to income tax under Case VI of Schedule D on that profit, in circumstances where the Commissioners had found that the transaction was not taxable under Case I as a trading venture. The House of Lords held that he could not, because the profit did not have the character of income and represented a capital accretion.

Lomax v Peter Dixon & Son Ltd [1943] 1 KB 671, (1943) 25 TC 353

33. This case is notable for the lucid and penetrating analysis by Lord Greene MR (giving the only reasoned judgment in the Court of Appeal) of the approach which the court should adopt, and the circumstances which it should take into account, in deciding whether any discount at which a loan is made and/or any premium payable on its redemption are of an income or capital nature. The other two members of the court were MacKinnon and Du Parcq LJJ. The report of the case in Tax Cases reveals (at 367) that MacKinnon LJ had read the judgment of the Master of the Rolls with such "pleasure and admiration" that he "consigned [*his*] efforts to the waste paper basket".

34. The taxpayer company was a manufacturer of newsprint. In 1930 it formed a Finnish subsidiary for the purpose of supplying it with wood pulp. By November 1933,

it had made advances to the subsidiary of £319,600, repayable on demand. By an agreement dated 11 November 1933, the two companies made an agreement to fund the outstanding indebtedness, against a background of political tension between Finland and Russia. The fundamental terms were these:

(a) The Finnish company agreed to issue to its parent 680 notes of £500 each, amounting in all to £340,000. The rescheduled debt was 94% of this amount, so in effect the notes were issued at a discount of 6%.

(b) The notes were to bear interest at a commercial rate.

(c) The first hundred notes were to be repaid almost immediately, on 15 November 1933, and the remainder in equal instalments over 20 years from 6 April 1944.

(d) Each note was to be redeemed at a premium of 20%, if the profits of the Finish subsidiary in the previous year reached a specified level.

For the years from 1933 to 1940 inclusive, the proper number of notes were duly paid off at a premium. The Crown assessed the interest, discount and premiums to income tax under Schedule D, as income arising from securities. The taxpayer company argued that the discount and premiums formed part of a capital transaction. This contention was upheld by the Special Commissioners and (reversing Macnaghten J) by the Court of Appeal.

35. Lord Greene MR began his analysis by pointing out that it is sometimes obvious from the terms of the contract whether a receipt is to be regarded as capital or as income, but "in many cases mere interpretation of the contract leads nowhere" ([1943] 1 KB 671 at 675). He continued:

> "If A lends B £100 on the terms that B will pay him £110 at the expiration of two years, interpretation of the contract tells us that B's obligation is to make this payment; it tells us nothing more. The contract does not explain the nature of the £10. Yet who could doubt that the £10 represented interest for the two years? The justification for reaching this conclusion may well be that, as the transaction is obviously a commercial one, the lender must be presumed to have acted on ordinary commercial lines and to have stipulated for interest on his money. In the case supposed, the £10, if regarded as interest, is obviously interest at a reasonable commercial rate, a circumstance which helps to stamp it as interest."

36. Lord Greene then explained that a higher than usual rate of interest may reflect capital risk, but the interest does not thereby lose its character as such. On the other hand, if the capital risk is reflected in an obligation to pay an increased sum on maturity, the premium has the character of capital. The question whether a premium should be regarded as compensation for capital risk, or merely as deferred interest, will depend on evidence of the negotiations between the parties and the inferences to be drawn from the surrounding circumstances. As Lord Greene said, at 677:

> "I refer to these problems not to attempt to solve them but to show that there can be no general rule that any sum which a lender receives over and above the amount which he lends ought to be treated as income. Each case must, in my opinion, depend on its own facts, and evidence dehors the contract must always be admissible to explain what the contract itself usually disregards, namely, the quality which ought to be attributed to the sum in question."

37. Lord Greene then explained that the same principles applied to company debentures issued at a discount or redeemable at a premium, and said, at 679, that he could find no ground for distinguishing the case under appeal "from that of an ordinary issue of debentures by a trading company". If, at the date of the agreement, the taxpayer

company had lent to its Finnish subsidiary £319,600 to be secured by an issue of notes at a discount of 6% and repayable over 20 years at a premium of 20%, and bearing interest at a normal commercial rate, then:

> "the revenue authorities would not have claimed tax on the discount or the premium. The element of capital risk was quite obviously a serious one and the parties were entitled to express it in the form of capital rather than in the form of interest if they bona fide so chose."

38. Lord Greene also rejected a further argument by the Crown that the difference between the issue price and the nominal value of the notes was income from "discounts" within the meaning of Case III, Rule 1, paragraph (b) of the Income Tax Act 1918 (the ancestor of the provision which we have to consider). He traced this provision back to the Income Tax Act of 1805, and relied on the judgments of Rowlatt J and the House of Lords in *NPI v Brown* as authority that the provision had never been apt to catch discounts of a capital nature.

39. Finally, Lord Greene summed up his conclusions as follows, at 682-683:

> "It may be convenient to sum up my conclusions in a few propositions. (1) Where a loan is made at or above such a reasonable commercial rate of interest as is applicable to a reasonably sound security there is no presumption that a 'discount' at which the loan is made or a premium at which it is payable is in the nature of interest. (2) The true nature of the 'discount' or the premium (as the case may be) is to be ascertained from all the circumstances of the case, and, apart from any matter of law which may bear on the question (such as the interpretation of the contract), will fall to be determined as a matter of fact by commissioners. (3) In deciding the true nature of the 'discount' or premium in so far as it is not conclusively determined by the contract, the following matters together with any other relevant circumstances are important to be considered, namely, the term of the loan, the rate of interest expressly stipulated for, the nature of the capital risk, and the extent to which, if at all, the parties expressly took or may reasonably be supposed to have taken the capital risk into account in fixing the terms of the contract. In this summary I have purposely confined myself to a case such as the present where a reasonable commercial rate of interest is charged. Where no interest is payable as such, different considerations will, of course, apply. In such a case, a 'discount' will normally, if not always, be a discount chargeable under para (b) of r.1 to Case III. Similarly, a 'premium' will normally, if not always, be interest …"

The only modification which needs to be made to this summary, in our view, is that the true nature of a discount (or premium) is ultimately a question of law, to be determined in the light of the facts found by the fact-finding tribunal: see the authorities cited in paragraph 21 above.

Ditchfield v Sharp (1983) 57 TC 555, [1983] 3 All ER 681

40. In this case a company called Bergers issued a promissory note in 1969 to a Dutch company, Cel Euro NV, promising to pay £2,399,000, free of interest, in 1973. In 1970 the taxpayers, who were trustees of a settlement, together with others, purchased the note from Cel Euro, the trustees' contribution to the price being £1,321,904. The note was then held to maturity, when the trustees received £1,781,969, making a profit on their investment of £460,065. The Revenue assessed the profit to income tax, arguing that it was a "discount" of an income nature. There was an alternative assessment to CGT, in case the correct analysis was that the profit was of a capital nature.

41. The Special Commissioners upheld the trustees' argument that the profit was capital, but this conclusion was reversed by Walton J, whose judgment was upheld unanimously by the Court of Appeal.

42. The leading judgment in the Court of Appeal was delivered by Fox LJ, who at 568I identified the two questions for determination as, first, whether the trustees' profit arose from a discount received on a discounting transaction, and secondly, if so, whether it was a profit of an income nature. On the first question, he held, differing on this point from Walton J, that the relevant transaction was not the original issue of the promissory note in 1969, but rather the purchase of the note by the trustees in 1970. As Fox LJ said at 569D:

> "It was that second transaction which gave rise to the actual profit which is claimed to be taxable."

He held that this transaction was a "discount", within the dictionary definition of that term, because the trustees "acquired the note before maturity at an amount less than its face value". It was therefore "a plain case of a discount in a strict commercial sense" (569E).

43. On the second question, Fox LJ applied the principles laid down in *NPI v Brown* and *Lomax v Peter Dixon*. Since the taxpayers had called no evidence to indicate the true nature or quality of their profit, the only proper conclusion on the bare facts summarised above was that the profit was of an income nature. Since no interest was payable on the note, the discount fell to be treated as an income return unless there was evidence to displace that conclusion. Fox LJ said at 570G:

> "The holder of the discount must, one assumes, be getting a return for his money. It is up to him to demonstrate the capital quality of the discount if he asserts its existence. As regards the trustees' return on their money … the profit which was made by the trustees represented a return of about 11% per annum on a simple interest basis."

44. Fox LJ went on to reject two arguments advanced by counsel for the taxpayers. The first argument was that the court should concentrate on the original issue of the note, which was not a discounting transaction at all, but part of the consideration for the purchase and sale of property. Fox LJ answered this argument at 571B:

> "But the fact that the issue of the note formed part of such consideration seems to me immaterial. I can see no reason why a discounting transaction should not form part of a larger transaction which is itself a purchase and sale … I do not, therefore, think it helps the trustees to rely on the original transaction."

45. The second argument was that the note was not issued for a short term, but for a period of some three years. This argument, too, was rejected, partly on the basis of dicta by Lord Atkinson and Lord Sumner in *NPI v Brown* to the effect that the "length" of the bills was immaterial, but mainly on the substantial ground that the trustees should have brought evidence on the point before the Commissioners if they wished to rely on it.

46. May LJ delivered a concurring judgment. Importantly, he agreed with Fox LJ that the relevant transaction to be examined was the purchase of the note by the trustees in 1970: see 573A. He also agreed that it was "clearly a discounting transaction": ibid. On the second question, May LJ considered (mistakenly, as we have explained at para 21 above) that it was one of fact, not law, but nevertheless agreed with Fox LJ that, on the available evidence, the only conclusion open to the Commissioners in accordance with *Edwards v Bairstow* [1956] AC 14 was that the discount was of an income nature.

47. Waller LJ agreed, without adding anything.

***IRC v John Lewis Properties Plc* [2002] EWCA Civ 1869, [2003] Ch 513**

48. This was not a case about discounts, but counsel for Mr Healey rely on it as authority for the proposition that economic equivalence plays no part in the distinction between income and capital receipts. The taxpayer was the property holding company for the John Lewis group. In 1995 it entered into a rent factoring transaction, whereby it assigned to a bank the right to receive the rents from 5 properties from January 1996 to January 2001 (a period of 5 years) in return for an immediate lump sum payment of £25.5 million, which was calculated to represent the discounted value of the assigned rent. The Revenue argued that this lump sum was income in the taxpayer's hands, because (put shortly) it was a payment in return for future income, and operated as a substitute for the future rents.

49. This argument was accepted by Arden LJ, but the majority in the Court of Appeal (Dyson and Schiemann LJJ) disagreed. At [90], Dyson LJ said that "the way in which the lump sum has been calculated does not shed light on how it should be classified". Accordingly, "the fact that it is equivalent to the value of six years' rent discounted for early receipt tells one little or nothing about whether the lump sum is capital or income".

50. The core of Dyson LJ's reasoning may in our view be found at [94]:

> "The starting point is that, as between JLP and the bank, the single lump sum payment was not a payment of rent. In this respect, the case is fundamentally different from the prepayment by a tenant of a lump sum representing the discounted value of future rents payable by the tenant under a lease. It is common ground that a lump sum prepayment of rent by a tenant is income in the hands of the landlord. It retains its character as income, notwithstanding that it has been converted into a lump sum. In such a case, there is no disposal by the landlord of an asset. But in the present case there *was* a disposal of an asset. JLP's right to receive six years' rent was a chose in action which could be assigned for value. In my view, it is irrelevant that *the rent paid by John Lewis to JLP* would be income in the hands of JLP. The relevant question is: what was *the lump sum paid by the bank* in the hands of JLP? It is true that the payment was for future income. But it does not follow that the payment was of the same character as the future income for which it is was made. It seems to me that so to characterise the lump sum payment is to make the mistake of confusing the measure by which the payment is calculated with the payment itself …" [Emphasis in the original]

51. In the introductory section of his judgment, running from [68] to [73], Dyson LJ usefully set out some of the general principles which should guide the court in deciding whether a particular payment or receipt is to be classified as capital or income. We think it is important to have these general principles in mind, as well as the cases which deal specifically with discounts, and we therefore cite part of the guidance:

> "68. The question whether a payment is to be regarded as capital or income has troubled the courts for a very long time. There are statements of the highest authority which indicate that classification cannot be made by the application of something akin to a simple litmus test. Various guidelines have been given from time to time. But it has been repeatedly emphasised that much depends on the nature of the transaction and the matrix in which it is set. Thus, in *Van den Berghs Ltd v Clark* [1935] AC 431, 438-439 Lord Macmillan said:
>
> > 'While each case is found to turn upon its own facts, and no infallible criterion emerges, nevertheless the decisions are useful as illustrations and as affording indications of the kind of consideration which may relevantly be borne in mind in approaching the problem'.
>
> 69. In *Strick v Regent Oil Co Ltd* [1966] AC 295, 313 Lord Reid said:

> 'So it is not surprising that no one test or principle or rule of thumb is paramount. The question is ultimately a question of law for the court, but it is a question which must be answered in light of all the circumstances which it is reasonable to take into account, and the weight which must be given to a particular circumstance in a particular case must depend rather on common sense than on strict application of any single legal principle.'

70. Similar observations were made by Lord Morris of Borth-y-Gest, at p 328B, and Lord Upjohn, at pp 343A and 345C. Common sense is a necessary tool for any judge to use in reaching a decision. But it is not a sufficient one. The authorities do provide some assistance in pointing the way to finding what circumstances are relevant …

…

73. One final introductory observation. In relation to the classification of expenditure, Dixon J said in *Hallstroms Pty Ltd v Federal Comr of Taxation* 72 CLR 634, 648:

> 'What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.'

It is common ground that this approach should be applied equally to the classification of receipts."

Discussion

52. In the light of the cases we have examined, how is the profit which Mr Healey realised on the sale of the partially stripped ANZ FRN which he bought from KB to be characterised?

53. We begin with the crucial point, for which *Ditchfield v Sharp* is clear authority, that the question has to be answered by looking at the transaction which Mr Healey entered into, because that is the transaction which gave rise to the profit in his hands. What, then, did Mr Healey buy? He bought a FRN which had been issued on standard commercial terms by a bank with a high credit rating, but which had been deliberately modified by the removal of the seven interest coupons covering the period of 21 months from 13 December 2001 to 12 September 2003. The price which Mr Healey paid to KB for the FRN was calculated by reference to the discounted value of the seven interest payments which he was not going to receive. By contrast, when Mr Healey sold the FRN on 12 September 2003, immediately after coupons 9 to 12 had been re-attached, the price which he obtained for it was only £3,000 less than its par value of £30 million. The reason for this, of course, was that the FRN now carried a commercial floating rate of interest over the remaining period of one year until its redemption at par on 13 September 2004. Mr Healey's profit represented the difference between the discounted price which he paid on 11 December 2001 for the ANZ FRN in its modified form, and the price which he obtained for it on the market, after it had been restored to its original form, 21 months later.

54. It is now common ground that Mr Healey's profit was a profit on a discount within the meaning of Case III, paragraph (b). The reason for this, as it seems to us, is as simple as it was in *Ditchfield v Sharp*: Mr Healey acquired the FRN, before maturity, at an amount less than its face value. That was a discount in the normal commercial sense of the term. The next question, therefore, is whether the discount was of a capital or an income nature. We emphasise that it is the character of the *discount* which has to be

ascertained, not the character of the legal rights which Mr Healey bought and sold, although they are a relevant part of the circumstances which have to be taken into account.

55. Clearly, no part of the discount was intended to compensate Mr Healey for capital risk. ANZ was a "blue chip" borrower, with a high credit rating. The ANZ FRN traded on the market at around its par value both when it was bought by KB and when it was sold by Mr Healey. Equally clearly, in our view, the purpose of the discount was to compensate Mr Healey for the absence of interest on his investment over the period covered by the seven stripped coupons. On analysis, the position is just a slightly more complicated version of that in *Ditchfield v Sharp*, where the intermediate purchasers of the promissory note made a profit to maturity which reflected the fact that the note bore no interest. In the present case, the right to interest was stripped out for a fixed period, and the stripped interest was payable to KB beneficially during that period. But from the perspective which matters, namely that of Mr Healey, the position was in our judgment the same in all essential respects as it would have been if he had bought a non-interest bearing note issued at a discount. In cases of that nature, as the authorities show, the conclusion that the discount is of an income nature is all but irresistible, unless the taxpayer adduces evidence to establish the contrary.

56. Furthermore, to characterise the discount as one of an income nature would not in our judgment involve falling into either the trap of characterisation by economic equivalence, or the trap of confusing the measure of a payment with its essential nature. Rather, the conclusion would follow from a proper assessment of the reasons which led Mr Healey to pay the discounted price for the modified FRN. The only reason, on the evidence before the FTT, lay in the absence of an income return on the note for Mr Healey during the stripped period. It is wholly immaterial to this analysis that, during the same period, the interest was payable to KB.

57. It is a further advantage of this approach, in our view, that it accords with common sense, and with the emphasis placed by Dixon J in the *Hallstroms* case "on what the expenditure is calculated to effect from a practical and business point of view".

58. So far, everything seems to us to point in favour of the conclusion that, as a matter of law, the profit arising to Mr Healey from the discount was indeed of an income nature. The contrary conclusion was pressed upon us, with characteristic skill and vigour, by Mr Prosser QC, but in our view his submissions miss the mark because they fail to concentrate on the right target, which is the nature of the discount in the hands of Mr Healey.

59. Thus, Mr Prosser argued that the transactions in the present case differ fundamentally from those in *NPI v Brown* and *Ditchfield v Sharp*, because in those cases the bill or note carried no interest as such, but was issued at a discount so that the principal included a sum which was in reality interest to compensate the lender for the use of his funds. By contrast, submits Mr Prosser, the ANZ FRN was issued at par and the £30 million principal carried interest at a commercial rate. Therefore the £30 million was wholly capital in nature, and in so far as Mr Healey's profit arose from sale of the right to receive the £30 million principal, it was a profit from the sale of a right to receive a capital sum, and so must likewise be of a capital nature. Mr Healey also sold the right to receive coupons 9 to 12, and part of his profit was attributable to the increase in value of that right during his period of ownership. However, this makes no difference to the analysis, says Mr Prosser, because it is settled law that the proceeds of sale of a promissory note including the right to interest are wholly capital in nature, subject to any legislation to the contrary: see *Wigmore v Thomas Summerson & Sons*

Ltd [1926] 1 KB 131. As Rowlatt J said at 143, dismissing the Crown's argument that there should be an apportionment of the purchase price:

> "The truth is that the seller does not receive 'interest' from the buyer, and it is interest which is the subject matter of the taxation. He receives the price of the expectancy of interest, and that is not the subject matter of the taxation. The whole contention on behalf of the Crown depends upon the fallacy that the price of the expectation of interest is interest."

60. Similarly, submits Mr Prosser, it is also settled law, again in the absence of legislation to the contrary, that the proceeds of a separate sale of an interest coupon are capital, not income: see *IRC v Paget* [1938] 2 KB 25 (CA), where Lord Romer said at 44-45:

> "In these circumstances the only question to be decided is whether the proceeds of sale of a right to receive income in the future can be treated as income for the purpose of the Income Tax Acts. The question thus broadly stated plainly admits of but one answer; and that answer must be in the negative. The proceeds of the sale for a lump sum of an annuity, for instance, are capital in the hands of the vendor and not income. And this is true even when the subject of the sale is not the annuity for its whole duration but the right to be paid the annuity for a number of years or even for one year."

61. In our judgment this approach, and these authorities, would be very much in point if the question for the FTT had been how to characterise the sum received by Mr Healey upon sale of the ANZ FRN. But that is not the relevant question. The issue is how to characterise the discount, and that depends on an examination of the relevant discounting transaction from the point of view of Mr Healey. For that purpose, Mr Healey's purchase and sale of the ANZ FRN have to be considered together, and the crucial point is the function which the discount performed in the context of Mr Healey's investment.

62. We should also comment on an example which Mr Prosser and Mr Bradley gave in paragraph 53 of their skeleton argument, designed to show that a discounting transaction may be of a capital nature even if the discount does not reflect capital risk. The example reads as follows:

> "For example, suppose company X which has a good credit rating, issues a £10m nominal promissory note at par. The note is redeemable at par in 5 years and carries interest at a fixed rate of 0.5% which is an arm's length commercial rate at the time of issue. Two years later, when interest rates have increased substantially, the holder of the note decides to sell it in the market. Although X has a good credit rating, the note will inevitably be valued at a discount to £10m to reflect the fact that it carries a very low rate of interest until redemption. The purchaser holds the note to redemption. He thereby makes a profit. His transaction is plainly a discounting transaction, but equally plainly his profit is not of an income nature. This is because the right which he acquired is a right to receive £10m which does not include interest: no part of the £10m represents a return for X's use of money. The fact that the purchaser acquires the note at a discount does not alter this."

63. We have no quarrel with this example, but do not consider that it helps in the resolution of the present case. The reason for the "discount" in the example is simply that the right to receive interest at 0.5% from the date of the intermediate purchase to maturity would not provide the purchaser with a market return on an investment of £10 million. The market price therefore falls to a level at which, taken in conjunction with the 0.5% coupon, an acceptable post-tax rate of return will be achieved. However, the transaction is still one of sale and purchase of the note in its original form. That is

inherently a transaction of a capital nature, if undertaken by a person who is not a trader in securities: it is the sale of an asset for its current market value.

64. As Rowlatt J explained in *NPI v Brown*, loc.cit., at 66:

> "It is true that in some cases obligations in future expressly bearing interest may command only a lower present value not merely because of the uncertain credit of the obliger [*sic*], but because of the insufficiency of the rate of interest borne by the security in the view of the market at the moment. But even to this extent, the amount gained by buying and holding the security is not annual profits and gains. It is a difference in the value of the security as a whole as a marketable commodity. It seems to me that in each case one must look at the real nature of the transaction and see whether the purchase of the future obligation at a discount is really an investment of money at interest or not."

65. We do not think that a "discount" of that nature would be a discount within the meaning of Case III at all; and, even if it were, it would plainly be a discount of a capital nature.

66. In the present case, by contrast, the discount arises not from a sale on the market of the ANZ FRN in its original form, but from the sale by KB to Mr Healey, in a private transaction, of the note stripped of coupons 2 to 8 for a specially calculated price. The result of stripping the coupons was to make the transaction, as between KB and Mr Healey, analogous to the issue of a zero-coupon note at a discount from par which represents interest on the purchaser's investment. The analogy is not exact, because coupons 1 and 9 to 12 were also acquired by Mr Healey; but it is close enough, in our view, to justify the conclusion that the discount should be characterised as of an income nature.

The Decision of the FTT

67. We have so far made no reference to the detailed reasoning of the FTT which led them to conclude, first, that there was a discount within the meaning of Case III and, secondly, that it was of an income nature. We do not thereby intend any discourtesy to the FTT. On the contrary, we have found much of value in their thoughtful discussion of the questions, and our reasons for concluding that the discount was of an income nature are, we think, very much the same as theirs. Since, however, the questions are ones of pure law, and they arise on simple and undisputed facts, it seemed to us more profitable to address the questions directly rather than through the prism of the FTT's own reasoning. For those who are interested, the Decision is available to the public in the usual way and has also been reported: see the references in paragraph 9 above.

68. There is, however, one subsidiary part of the FTT's reasoning on the second question with which we respectfully disagree. In paragraph [46], the FTT found support for their conclusion that the discount had the character of income in the terms of KB's client brochure, which stressed the intention to provide an enhanced after-tax return, and in the fact that the Flexi-Note package was put forward as suitable for trustees. The FTT said that, if there were competing claims between income and capital beneficiaries, trustees who had invested in the package would "be bound to treat the profit on the discount, or a large part of it, as income". In our view neither of these points carries any weight in the present context. The terms of the brochure merely show the basis on which KB were marketing the scheme, while the question of apportionment of receipts between capital and income beneficiaries is a matter of internal trust administration which has nothing to do with the characterisation of the relevant receipt for tax purposes.

Result

69. For the reasons which we have given, Mr Healey's appeal will be dismissed.

Hon Mr Justice Henderson

Judge Colin Bishopp

Released 25 March 2015