(FIRST DIVISION)—8 AND 9 MARCH AND 1 APRIL 1977

HOUSE OF LORDS—11 AND 12 JANUARY AND 15 FEBRUARY 1978

B

Aberdeen Construction Group Ltd. *v*. Commissioners of Inland Revenue(1).

Corporation tax—Chargeable gains—Disposal by holding company of its shares in subsidiary company on condition that holding company waived repayment of its loans to the subsidiary—Whether consideration given for shares alone or shares and loans—Whether the loans were debts on a security and an allowable C *loss accrued—Whether the amount of the loans was an allowable deduction in computing the gain or loss on the disposal—Finance Act* 1965 (*c* 25), *Sch* 7, *para* 11; *Sch* 6, *paras* 4(1) (*b*), 8.

R.F. Ltd., a subsidiary of the Appellant holding company ("A.C.G. Ltd.") was formed in 1957 to carry on the business of drilling and blasting rock. By 1960 A.C.G. Ltd. had acquired the whole of the issued share capital of R.F. Ltd. D for £114,024 and as at 31 December 1970 had made unsecured loans to that company totalling £500,000. The trading position of R.F. Ltd. had deteriorated and in March 1971 A.C.G. Ltd. agreed to sell its shares in R.F. Ltd. to W. Ltd. on condition that it waived its loans to R.F. Ltd., which it did. An assessment to corporation tax for the relevant period was made on the basis that there was a capital gain of £135,976 on the disposal of the shares and that the waiver of E the loans was of no relevance for capital gains tax purposes. On appeal to the Special Commissioners A.C.G. Ltd. contended that (i) it had disposed of both shares and loans and in any event the loans qualified as "debts on a security" within Sch 7, para 11(1), of the Finance Act 1965 and a loss had accrued on their disposal or waiver; (ii) alternatively, the making or waiver of the loans was deductible expenditure under Sch 6, para 4(1)(*b*), in computing the gain F or loss on the disposal of the shares; (iii) alternatively, the value of R.F. Ltd. shares being in part derived from the loans and their waiver, Sch 6, para 8, applied and the consideration for the shares should be taken as nil since they were worthless unless the loans were waived. The Commissioners held (i) that (*a*) on the loan debt being waived there was an unconditional contract under Sch 10, para 10, Finance Act 1971, to dispose of the shares alone for £250,000 G and (*b*) the loan debt was not a debt on a security so that its waiver could not result in an allowable loss; (ii) that the loan debt or its waiver was not expenditure on the shares and did not affect their state or nature within para 4(1)(*b*); (iii) that Sch 6, para 8, could not apply because as the loan was not a debt on a security there could not be a computation under Sch 6 "in respect of the other asset", i.e. the loan debt. They dismissed the appeal.

H The Court of Session, unanimously dismissing the appeal, held (1) that the Special Commissioners were wrong in applying Sch 10, para 10, Finance Act 1971, but nevertheless correct in holding (*a*) that the consideration paid was for the shares alone as there was only one disposal—that of the shares—to W. Ltd. and (*b*) that the loans of £500,000 did not constitute "a debt on a security" within the meaning of Sch 7, para 11(1), as they were simple unsecured debts;

(1) Reported (CS) [1977] STC 302; (HL) [1978] AC 885; [1978] 2 WLR 648; [1978] 1 All ER 962; [1978] STC 127; 122 SJ 249.

(2) that for the reasons given by the Special Commissioners the loans or their waiver were not deductible expenditure under Sch 6, para 4(1)(*b*), in computing the gain or loss on the disposal of the shares; (3) that for the reasons given by the Special Commissioners Sch 6, para 8, did not apply and furthermore the extinction of one asset as a precondition of the sale of another could not be described as a merger of the two. A

Held, in the House of Lords, (1) allowing the appeal to this extent, (Viscount Dilhorne and Lord Russell of Killowen dissenting) that the consideration was paid both for the shares and for the waiver of the loan, and the case should be remitted to the Special Commissioners to apportion the consideration between those two obligations and to adjust the assessment accordingly; (2) that the loan debt was not a debt on a security; and (3) that, for the reasons given by the Court of Session, Sch 6, para 8, did not apply. B C

CASE

Stated for the opinion of the Court of Session as the Court of Exchequer in Scotland under the Taxes Management Act 1970, s 56.

1. At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held (by special arrangement between the parties) at London on 27 November 1974 Aberdeen Construction Group Ltd. (hereinafter called "Aberdeen") appealed against an assessment to corporation tax for its accounting period ended 31 December 1971 made in an amount of £10,000. D

2. The question for our decision concerned the treatment for the purposes of computing the chargeable gains component in Aberdeen's total profit for the purposes of assessment to corporation tax of losses incurred in respect of loans made to certain subsidiary companies, which loans were written off when such companies were disposed of. The appeal was opened and argued in relation to the writing off of Aberdeen's loan to one of such subsidiaries (Rock Fall Co. Ltd.); it was agreed between the parties that our decision in relation to the loan to Rock Fall would govern the treatment of the loans to the other two companies. E F

3. The following witness gave evidence before us: Mr. Alan Chapman, a director and the secretary of Aberdeen since 1967.

4. The following document was proved or admitted before us, and is annexed to this case as exhibit A(1): contract for sale by Aberdeen of the whole of the issued share capital in Rock Fall Co. Ltd.

5. As a result of the evidence both oral and documentary adduced before us we find the following facts proved or admitted: G

(1) Aberdeen was registered as a limited company in 1925 in the name William Tawse Ltd. Its name was changed to Aberdeen Construction Group Ltd. in 1967, when five public companies merged. These five merging companies had interest in various other companies which resulted in Aberdeen becoming a holding company controlling 22 companies altogether. H

(2) The interests of these 22 companies and others added since 1967 include building, civil engineering, concrete manufacture, quarrying, builders' merchanting, mechanical and electrical engineering, property development, investment and (during the time when Aberdeen owned Rock Fall) underwater drilling and blasting.

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(1) Not included in the present print.

A (3) The various companies operate throughout Scotland. Two building companies operate in England, one from Southampton and one from Chesterfield. The group at present consists of 32 companies, 16 of which are non-active, their interests having been merged with other group companies.

(4) Rock Fall was formed in 1957 to carry on a business of a specialist nature involving drilling and blasting of rock. It was successful and obtained B many customers on the civil engineering and quarrying fields, but its then proprietors could not find capital for the very expensive equipment needed for expansion. In June 1960 Aberdeen, which was one of its customers, made a loan to it, and subscribed for 4,600 of its shares at par. In February 1961 Aberdeen purchased the 35,400 other issued shares, Rock Fall thus becoming its wholly-owned subsidiary; at later dates the issued capital was increased to C 125,000 shares, Aberdeen subscribing for the newly issued shares at par. The total cost to Aberdeen of the shares it purchased and subscribed for was £114,024.

(5) During the 1960s Rock Fall developed underwater drilling and blasting techniques which were utilised in many parts of the world. As this work increased, its plant and working capital requirements escalated. These require- D ments were met by way of loans from Aberdeen. The moneys so borrowed by Rock Fall were spent on barges and underwater drilling equipment and in financing the work in progress. These loans totalled £500,000 at 31 December 1970, having built up to that figure in the period between 1961 and 1968. When Aberdeen acquired the shares of Rock Fall in 1960, 1961 and later there was no obligation on Aberdeen to make loans to Rock Fall and the loans when made E were not secured on Rock Fall's assets.

(6) During 1970 Rock Fall's trading position deteriorated. Aberdeen's investment in Rock Fall amounted to £614,024 (i.e. £114,024 being the cost of the shares and £500,000 loan). Had it been possible to utilise Rock Fall's existing plant fully Aberdeen could have expected to get a reasonable return on this and eventually to obtain repayment of the loan, but large contracts F obtainable in Australia and in Europe would have meant yet more expenditure on plant which was difficult to move. Accordingly a purchaser of Rock Fall was sought and there were negotiations (conducted at arm's length) with Bos Kalis Westminster Dredging Group N.V. (hereinafter called "Westminster"), who eventually purchased Rock Fall.

(7) The terms of the sale to Westminster are contained in a letter dated G 10 March 1971 (exhibit A). These terms were duly implemented. They contained provisions (*inter alia*) that (*a*) Westminster would buy the whole of the issued share capital of Rock Fall for £250,000; (*b*) Aberdeen would waive its loan of £500,000 to Rock Fall; (*c*) the effective date of the sale would be 31 December 1970.

(8) Aberdeen wrote off the £500,000 loan in its balance sheet at 31 December H 1970. The financial result of the sale was thus as under:

	£
Cost of Rock Fall shares	114,024
Loan written off	500,000
	614,024
I Proceeds of disposal	250,000
	364,024.

The amount of £364,024 was debited to Aberdeen's capital reserve on its balance sheet at 31 December 1970. A

(9) The assessment under appeal was made upon the basis that Aberdeen had made a capital gain by the disposal for £250,000 of Rock Fall shares which had originally cost £114,024.

6. It was contended on behalf of Aberdeen:

(1) that what Aberdeen had disposed of for £250,000 was not the Rock Fall shares *simpliciter*, but all the rights it had in Rock Fall, i.e. the shares which had cost £114,024 and the loan which had cost £500,000; that such loan was "assets" for the purposes of capital gains tax, and in any event, should be treated as a "debt on a security" for the purpose of Finance Act 1965, Sch 7, para 11, and that the assessment should be computed accordingly; B

(2) in the alternative, that the making of the loan or the waiver of the loan was "expenditure . . . incurred on the asset" (i.e. the shares) ". . . for the purpose of enhancing the value of the asset" within Finance Act 1965, Sch 6, para 4(1)(*b*) and accordingly was deductible in computing any gain on disposal of the Rock Fall shares; C

(3) in the alternative, that the value of the Rock Fall shares was in part derived from the loan and its waiver; that accordingly the provisions of Sch 6, para 8, should be applied in making the computation for the purpose of the assessment, the consideration for the sale having been paid not only for the shares but also for the waiver, and that on an apportionment the consideration for the shares should be taken as nil since the shares were worthless unless the loan was waived; D

(4) that for corporation tax purposes Aberdeen made a loss of £364,024 and that the assessment be adjusted accordingly. E

7. It was contended on behalf of the Commissioners of Inland Revenue:

(1) that Aberdeen received the £250,000 for the Rock Fall shares, and received nothing for the waiver of the debt;

(2) that the loan was not a debt on a security within Sch 7, para 11;

(3) that neither the loan nor the waiver was expenditure on the shares within Sch 6, para 4(1)(*b*); F

(4) that Sch 6, para 8, had no application as no assets had been merged nor were any of the other conditions for that paragraph to operate present;

(5) that for corporation tax purposes Aberdeen made a chargeable gain on the sale of the Rock Fall shares of £250,000 minus £114,024 i.e. £135,976, and the assessment under appeal should be adjusted accordingly. G

8. We, the Commissioners who heard the appeal, took time to consider our decision and gave it in writing on 10 December 1974 as follows:

(1) Whatever may be the broad merits of this appeal, in our judgment the provisions of the governing legislation point inescapably to the conclusion that Aberdeen is fixed with a chargeable gain on the basis of a disposal of the Rock Fall shares for £250,000. H

A (2) Aberdeen's first and principal contention was to the effect that it had disposed of its whole interest, as proprietor and loan creditor of Rock Fall, in one transaction, for £250,000, or that that is the way the transaction ought to be viewed. We are unable to agree; as we see it, Aberdeen contracted to sell the Rock Fall shares and the contract was conditional upon (*inter alia*) Aberdeen's waiver of its loan debt. By virtue of s 56 and para 10 of Sch 10 to B the Finance Act 1971 Aberdeen's disposal of the shares must be treated as made at the time when the condition was satisfied (i.e. when the loan debt was waived). Accordingly, whatever may be the date when the waiver was effected, the disposal of the shares was (for the purposes of the relevant legislation) made when the contract became unconditional. We are therefore left with this, that Aberdeen disposed of the shares for £250,000 under an unconditional C contract. Looking at it this way, as we think we are forced to do, there seems to be no room for the contention put to us.

(3) *Schedule* 6, *para* 4, *Finance Act* 1965.

The question here is whether the loan or the waiver of the loan debt was "expenditure . . . incurred on the asset" (i.e. the shares) ". . . for the purpose of enhancing the value of the asset, being expenditure reflected in the state or D nature of the asset at the time of the disposal . . .." Assuming (but without deciding) that the loan or the waiver of the loan debt was "expenditure incurred" and that it was incurred "for the purpose of enhancing the value of the asset", it would, in our judgment, be straining language to say it was incurred "on the asset" or that it was "reflected in the state or nature of the asset". The loan was made to enable Rock Fall to acquire plant and working E capital; the debt was waived for the purpose of the contract for disposal of the shares; the expenditure was not incurred on the shares. The loans may have affected the value of the shares when they were made; we do not know, as it would not necessarily follow; the waiver certainly did, but in neither case did it affect their state or nature, which remained unchanged.

(4) *Schedule* 6, *para* 8.

F Whatever may be the application to a case such as the present of the opening words of this paragraph (i.e. down to "in the same ownership"), we meet what seems to us to be an impassable obstacle in the operative part—"the sums allowable as a deduction in a computation under this Schedule in respect of the other asset" (i.e. the loan debt) "under paragraphs (*a*) and (*b*) of paragraph 4(1) of this Schedule shall . . .", etc. The fact is that nothing could be G allowable as a deduction in any such computation, in as much as no such computation could ever be made. The "other asset" is the loan debt, and, as this was not a "debt on a security", no chargeable gain or relevant loss could accrue on its disposal, *vide* para 11 of Sch 7. Accordingly, in our judgment, there is nothing on which para 8 can bite.

(5) We dismiss the appeal and leave the figures to be agreed.

H 9. Figures were agreed between the parties and on 7 July 1975 we adjusted the assessment accordingly by reducing it to nil.

10. The Appellant immediately after the determination of the appeal declared to us its dissatisfaction therewith as being erroneous in point of law and in due course required us to state and sign a Case for the opinion of the Court of Session as the Court of Exchequer in Scotland, which Case we have I stated and signed accordingly.

The question of law for the opinion of the Court is whether we erred in law in our decision set out in para 8 hereof. A

R. A. Furtado } Commissioners for the Special Purposes of
J. G. Lewis } the Income Tax Acts.

Turnstile House,
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15 June 1976

The case came before the First Division of the Court of Session (the Lord President (Emslie) and Lords Johnston and Avonside) on 8 and 9 March 1977, when judgment was reserved. On 1 April 1977 judgment was given unanimously in favour of the Crown. C

The Dean of Faculty (*J. P. H. Mackay Q.C.*) and *R. D. Mackay* for the Company.

W. D. Prosser Q.C. and *J. A. D. Hope* for the Crown.

Emmerson v. *Computer Time International Ltd.* 50 TC 628; [1976] 1 WLR 749; [1977] 1 WLR 734 was cited in argument in addition to the case referred to in the judgments. D

The Lord President (Emslie)—The Appellants appealed to the Special Commissioners against an assessment to corporation tax for the accounting period which ended on 31 December 1971. The particular issue was whether in computing the Appellants' capital gains component for the purposes of this assessment the Appellants should be held to have made chargeable gains or allowable losses when they disposed of their shareholding in a number of subsidiary companies, having written off loans which they had made to these companies. Before the Commissioners the case of the Appellants' disposal of the whole share capital in Rock Fall Co. Ltd. was taken as a test case. The result of that case was dismissal of the taxpayers' appeal and this appeal is taken against the decision of the Commissioners. E F

The Appellants were, on and before 10 March 1971, a holding company, one of whose wholly owned subsidiaries was Rock Fall Co. Ltd. (hereinafter referred to as "Rock Fall"). This company was formed in 1957 to carry on a business of a specialist nature involving drilling and blasting of rock. It was successful and obtained many customers but its proprietors became unable to find the capital to buy the very expensive equipment needed for expansion. In June 1960 the Appellants, who were then merely customers of Rock Fall, lent some money to Rock Fall, and subscribed for some of its shares at par. Shortly thereafter the Appellants acquired the remainder of Rock Fall's issued share capital, and later, all subsequent issues of the increased capital at par. The total cost of the whole of the shares of Rock Fall ultimately owned by the Appellants was £114,024. During the 1960s Rock Fall developed underwater drilling and blasting techniques which were employed in many parts of the world. As the work increased Rock Fall's plant and working capital requirements escalated, and were met by further loans from the Appellants. By 31 December 1970 the whole of the loans made by the Appellants to Rock Fall amounted to £500,000. G H

A None of these loans was secured. During 1970 Rock Fall's trading position deteriorated. Had it been possible to utilise Rock Fall's existing plant fully the Appellants could have expected to get a reasonable return on their shareholding and, eventually, to obtain repayment of the loans. Certain large contracts were, it seems, obtainable in Australia and in Europe but only if there was further expenditure on plant which was difficult to move—expenditure which the B Appellants were no longer able to finance.

As the Case stated by the Special Commissioners shows, the Appellants in these circumstances sought a purchaser for Rock Fall "and there were negotiations (conducted at arm's length) with Bos Kalis Westminster Dredging Group N.V. (hereinafter called 'Westminster') who eventually purchased Rock Fall." The terms of the transaction between the Appellants and Westminster are set out C in a letter from Westminster dated 10 March 1971 thus:

"We hereby offer on behalf of Westminster Dredging Group Ltd., subject to the undernoted conditions to purchase the whole issued share capital of Rock Fall Co. Ltd. of Barrhead, Scotland, for the sum of £250,000. The conditions are: 1. Aberdeen Construction Group Ltd. waive the loan to Rock Fall Co. Ltd. which presently stands at £500,000. 2. D Taxation losses accumulated as at this date remain for the benefit of the purchaser. 3. Net Current Assets of £58,732 as shown in the draft Balance Sheet as at 31st December 1970 which is attached and initialled by representatives of both companies are guaranteed by the Vendors. Any variation in the said sum shall be made good by the Vendors or paid over by the Purchaser as at 31st December 1971 without any adjustment for interest. E 4. The said sum of £250,000 is due and payable as at 10th April 1971. 5. Notwithstanding the date hereof the effective date of transfer of the shares is to be at 31st December 1970, and the Vendors will procure that the transfer of the shares will be properly effected into such names as will be notified."

All that remains to be said is that the Appellant wrote off the loans of £500,000 F in their balance sheet at 31 December 1970 and that the financial result of implementing the terms of the transaction with Westminster, as the Special Commissioners have expressed it, was as follows:

	£
"Cost of Rock Fall shares	114,024
Loan written off	500,000
G	614,024
Proceeds of disposal	250,000
	364,024.

The amount of £364,024 was debited to Aberdeen's capital reserve H on its balance sheet at 31 December 1970."

The assessment under appeal proceeded, *inter alia*, upon the basis that the Appellants had made a capital gain by disposing to Westminster for £250,000 the share capital of Rock Fall for which they had paid £114,024. The Special Commissioners by their decision have confirmed that this basis was sound in law and the Appellants challenge this decision before us upon a number of I grounds, each of which involves the proposition that the loans to Rock Fall ought, in some way, either in whole or in part, to have been brought into the

(The Lord President (Emslie))

calculation. There is no doubt that Rock Fall's debt of £500,000 to the Appellants was an asset of the Appellants for the purposes of the capital gains tax provisions of the Finance Act 1965. There is equally no doubt that by waiving the loans, thus extinguishing the debtors' obligation, the Appellants made a disposal of that asset for the purposes of these provisions. In these circumstances it is convenient, first of all, to look at this disposal by itself on the assumption that by writing off the debt the Appellants made a loss equal to the amount of the debt, viz., £500,000. The particular question to be answered is whether that loss would constitute, for capital gains tax purposes, an "allowable loss". The answer to this question turns upon para 11(1) of Sch 7 to the Act of 1965 which provides as follows: A B

> "Where a person incurs a debt to another, whether in sterling or in some other currency, no chargeable gain shall accrue to that (that is the original) creditor or his legatee on a disposal of the debt, except in the case of the debt on a security (as defined in paragraph 5 of this Schedule)." C

It will be understood that under the capital gains tax legislation it follows that if, in the case of a particular disposal of an asset, no chargeable gain can accrue, no allowable loss can emerge either. From an examination of para 11(1) it is clear that, unless the loan to Rock Fall was "a debt on a security" as distinct from a simple unsecured loan, the disposal of the debt can give rise to neither a chargeable gain nor an allowable loss. For the Appellants it was argued that the loan was "a debt on a security" within the meaning of para 11(1). Paragraph 5(3) of Sch 7 does not define this expression. It merely defines what the word "security" includes in terms which at least allow one to say with confidence that a debt on a security need not be a secured debt. The remainder of the definition makes it difficult to discern any indispensable characteristic of "a security" but there is no practical distinction in this case between loan stock of Rock Fall, which would be included within the meaning of "security", and the loans granted by these Appellants to Rock Fall, for the Appellants owned the whole share capital of the debtor company and could at any time, to protect their loan, have procured the issue of loan stock by Rock Fall in their favour. All that is absent in this case is a document or certificate acknowledging the loan and the loans *in cumulo* can properly be regarded as a debt on a security. In my opinion the argument for the Appellants on this question is unsound. To be a debt on a security one must have "a security" on which there is a debt. What then is "a security" within the meaning of para 11(1)? Reference to para 5(3) of Sch 7 shows that it is concerned with "conversion of securities" and with the word "security" itself and the subsection provides in particular as follows: D E F G

> " 'security' includes any loan stock or similar security whether of the Government of the United Kingdom or of any other government, or of any public or local authority in the United Kingdom or elsewhere, or of any company, and whether secured or unsecured."

Upon a proper construction of that subsection I am persuaded that what is in contemplation is the issue of a document or certificate by the debtor institution which would represent a marketable security, as that expression is commonly understood, the nature and character of which would remain constant in all transmissions. Support for this view is to be found in the opinions of Lords Migdale and Cameron in *Cleveleys Investment Trust Co.* v. *Commissioners of Inland Revenue*[1] 1971 SC 233 in which they offer their interpretation, *obiter*, H I

(1) 47 TC 300.

A on the meaning of "security" for the purposes of para 11(1). Lord Migdale dealt with the point thus(1):

> "The word 'security' has two meanings. It may refer to some property deposited or made over or some obligation entered into by or on behalf of a person in order to secure his fulfilment of an obligation he has undertaken. Or it may refer to a document held by a creditor as evidence or a B guarantee of his right to repayment. (See the Shorter Oxford English Dictionary, *sub voce*.) I think that the words 'the debt on a security' refer to an obligation to pay or repay embodied in a share or stock certificate issued by a government, local authority or company, which is evidence of the ownership of the share or stock and so of the right to receive payment. This reading of this section enables me to give some effect to the words C 'and whether secured or unsecured'. If I take the words 'security' and 'secured' as meaning the same thing, these last words 'and whether secured or unsecured' have no meaning at all. 'The debt on a security' means debt evidenced in a document as a security."

Lord Cameron's treatment of the point included the following(2):

> ". . . whatever else it may mean, the phrase 'the debt on a security' is D not a synonym for a secured debt. Once the terms of paragraph 5 are examined, it becomes abundantly plain that the word 'security' in paragraph 11(1) is a substantive and refers to those securities which are or can be subject to a conversion. I would also draw attention to the fact that the word 'security' is also defined in paragraph 7(1) of Schedule 11, and this seems to me to make it very clear that the word 'security' as used in E paragraph 11 of Schedule 7 is given precisely that limited and specialised meaning which is stamped upon it by paragraph 5(3), to which I have already referred."

In the present case, accordingly, I am quite unable to regard the loans of £500,000 to Rock Fall as "a debt on a security" within the meaning of para 11(1). They were, in my opinion, no more than simple unsecured debts and a loss on their F disposal does not qualify as an allowable loss.

I now turn to consider the submission for the Appellants that the making of the loans and their waiver constituted deductible expenditure, within the meaning of para 4(1)(*b*) of Sch 6 to the 1965 Act, in computing the gain or loss on the sale of the Rock Fall shares to Westminster. The schedule is not concerned with "chargeable" gains or "allowable" losses but merely with the computation of G gain or loss on disposal of an asset. Paragraph 4(1)(*b*) thereof is in these terms:

> "Subject to the following provisions of this Schedule, the sums allowable as a deduction from the consideration in the computation under this Schedule of the gain accruing to a person on the disposal of an asset shall be restricted to . . . (*b*) the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of H enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal, and any expenditure wholly and exclusively incurred by him in establishing, preserving or defending his title to, or to a right over, the asset."

(1) 47 TC 300, at p 315. (2) *Ibid*, at p 318.

(The Lord President (Emslie))

According to the Appellants the money laid out by way of the loans was "expenditure" wholly and exclusively incurred "on" the share capital for the purpose of enhancing their value. The words "state or nature" must be applicable to incorporeal property and are wide enough to include every circumstance which can affect the value of such property. It follows that on the extinction of the loans this "expenditure" was reflected "in the state or nature" of the shares sold for they were then shares in a debt-free company and, having been worthless, acquired the value for which they were sold. Once again I am not persuaded that this argument ought to receive effect. It is permissible to suppose that the extinction of the debt owed by Rock Fall enhanced the value of its shares. To describe the making of the loans, or their waiver, as expenditure within the meaning of para 4(1)(*b*) of Sch 6 is however quite unacceptable. The making of the loan created rights and obligations and the waiver constituted an abandonment of the rights but in neither case was there the kind of expenditure with which para 4(1)(*b*) is concerned. In any event, by no reasonable stretch of the imagination is it possible to classify the making of the loans or their waiver as expenditure wholly and exclusively incurred "on" the shares and I find it impossible to say that either were reflected in the state or nature of the shares which were sold. The waiver of the loans may well have enhanced their value but what para 4(1)(*b*) is looking for is, as the result of relevant expenditure, an identifiable change for the better in the state or nature of the asset, and this must be a change distinct from the enhancement of value.

The next chapter of the argument for the Appellants was founded upon the terms of para 8 of Sch 6 to the Act of 1965. That paragraph provides as follows:

> "If and so far as, in a case where assets have been merged or divided or have changed their nature or rights or interests in or over assets have been created or extinguished, the value of an asset is derived from any other asset in the same ownership, an appropriate proportion of the sums allowable as a deduction in a computation under this Schedule in respect of the other asset under paragraphs (*a*) and (*b*) of paragraph 4(1) of this Schedule shall, both for the purpose of the computation of a gain accruing on the disposal of the first-mentioned asset and, if the other asset remains in existence, on a disposal of that other asset, be attributed to the first-mentioned asset."

In particular the argument was that the two assets of the Appellants—their shareholding and their loans—had been merged in the transaction with Westminster with the result (i) that the merged asset consisting of the shares in a debt-free company derived its value to some extent from the discharge of Rock Fall's debt, and (ii) that in terms of para 8 a proportion of the sum allowable as a deduction in respect of that debt—namely, the cost of its constitution under para 4(1)(*a*) of Sch 6—should be attributed to the disposal of the shares. In my opinion this argument fails to surmount the first obstacle which it encounters. To bring themselves within the protection of para 8 the Appellants relied only upon an alleged merger of two assets—the shares and the debt. The reference to "merger" within para 8, however, is a reference to the coalescence of two distinct assets to form a new asset, or to the amalgamation of two separate bundles of rights into one. On the assumption on which this argument was presented the asset disposed of consisted of the shares. These were the same shares, involving the same shareholders' rights, which the Appellants had acquired on purchase even if their value at the time of disposal had been influenced by the waiver of the loans. The rights of the Appellants in the loans were the distinct rights of creditors of Rock Fall none of which were transmitted

A by the disposal of the shares to Westminster. The simple fact of the matter is that these creditors' rights were extinguished to enable the shareholders' rights to survive as a saleable commodity and, to my mind, the extinction of one asset as a precondition of the sale of another could never properly be described as a merger of the two. It is unnecessary to explore the para 8 argument further but I feel bound to say, with the Commissioners, that para 8 envisages a situation B in which a computation under para 4(1)(*a*) or (*b*) would have been made had the asset in question not been merged with another and had been disposed of in its original state. In the case of a simple debt this computation would never have been made for a disposal by the original creditors could not have led to either a chargeable gain or an allowable loss.

So far I have considered the disposal of the debt of £500,000 by itself, and C the arguments of the Appellants which were presented on the assumption that the consideration paid by Westminster to the Appellants was in respect of the disposal of the shares only. These were, however, submissions of a subsidiary character and I now come to the primary submission for the Appellants which, I regret to say, the Special Commissioners failed to deal with on its merits because they considered, wrongly, that they were precluded from entertaining it D by s 56 of and para 10 of Sch 10 to the Finance Act 1971, the provisions of which were not in force at the time of the transaction with which this appeal is concerned. In the result I deal with the primary submission of the Appellants upon a case which might have been stated more fully and without the benefit of the views of the Commissioners thereon.

For the Appellants the primary submission was that the consideration paid E by Westminster was not given merely for the shares but for the shares and, *inter alia*, the waiver of the loans. In the result apportionment of the consideration must take place under para 21(4) of Sch 6. In developing this submission Counsel emphasised that the state of Rock Fall's accounts had everything to do with the value of the shares and that, since the waiver of the loans affected the value of the shares to be purchased by Westminster, that waiver enured for the F benefit of the acquiring shareholders. I am prepared to accept that the waiver of the loan enhanced the value of the shares which were the subject of the bargain with Westminster. The question is, however, whether the consideration paid by Westminster was in respect of anything but the shares. To that question there can be only one answer. On the facts found the consideration paid by Westminster was in respect of the disposal to them of the shares in Rock Fall and was G given for nothing else. The simple truth is that there were two separate disposals by the Appellants but only one of them was a disposal to Westminster. Westminster contracted to acqure the rights of the Appellants as shareholders and that is what they paid for. So far as the loans are concerned the Appellants waived them in a question with Rock Fall in order to be able to sell the shares to Westminster. The whole of the Appellants' rights as loan creditors of Rock Fall H were thus extinguished. Westminster neither wanted them nor acquired them, and the mere fact that the Appellants had to write off the Rock Fall debt in order to be able to find a purchaser for the Rock Fall shares affords no warrant for saying that any part of the price paid for the shares by Westminster was given by them as consideration for the waiver of the loans.

On the whole matter I would answer the question in the case in the negative I and dismiss the appeal.

Lord Johnston—By an offer dated 10 March 1971 Bos Kalis Westminster Dredging Group N.V. offered to buy the whole issued share capital of Rock Fall Co. Ltd. for the sum of £250,000 from the Appellants, Aberdeen Construction Group Ltd., subject to the condition, *inter alia*, that the Appellants should waive their loan to Rock Fall then standing at £500,000. The offer was accepted and the contract implemented. The Appellants wrote off the loan and the financial result of the Rock Fall transaction was as follows:

	£
Cost of Rock Fall shares	114,024
Loan written off	500,000
	614,024
Proceeds of disposal	250,000
	364,024

The amount of £364,024 was debited to the Appellants' capital reserve in its balance sheet at 31 December 1970. The Appellants were, however, assessed on the basis that they had made a capital gain by the disposal for £250,000 of the shares which they had acquired for £114,024. The Special Commissioners upheld the basis of the assessment and this appeal is taken against their determination.

The Appellants' primary contention was that the transaction between them and Westminster was a composite transaction involving one disposal for tax purposes; that the £250,000 was paid for the shares and the waiver of the debt of £500,000 due to them by Rock Fall and that there must be apportionment under para 21(4) of Sch 6 to the Finance Act 1965. It is clear that but for the waiver of the loan by the Appellants the value of the shares would have been less (indeed it may be that the shares would have been unmarketable), and I am prepared to consider the contention on that basis. But the waiver's enhancement of the value of the shares does not alter the fact that the waiver and the sale of the shares were two separate disposals. The first, the waiver, involved the Appellants and Rock Fall; the second, the Appellants and Westminster. Westminster acquired nothing under the first disposal; under the second it acquired the shares and only the shares. I am therefore unable to accept the Appellants' primary contention.

I turn now to deal shortly with the Appellants' subsidiary contentions, which were advanced on the basis that the £250,000 paid by Westminster was paid for the shares only. It was then contended, first, that the loan of £500,000 was a "debt on a security" in terms of para 11(1) of Sch 7 to the 1965 Act and was an allowable loss. Despite the promise of a definition of the phrase in para 5 of Sch 7, there is no such definition. But, as Lord Cameron said in *Cleveleys Investment Trust Co.* v. *Commissioners of Inland Revenue* 1971 SC 233, at page 244(1): "... whatever else it may mean the phrase 'the debt on a security' is not a synonym for a secured debt." But while it may not be necessary that the debt be secured it is clear that a debt by itself will not suffice. I agree with your Lordship in the Chair that what appears to be in contemplation is the issue of a document by the debtor which would represent a marketable security. No such document was issued to the Appellants by Rock Fall so far as the case shows and accordingly I reject this contention.

(1) 47 TC 300, at p 318.

A It was contended, second, that the making of the loan and its waiver was "expenditure wholly and exclusively incurred on the asset . . . for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal . . ." in terms of para 4(1)(*b*) of Sch 6 to the Act of 1965. As I have already said, I am prepared to assume that the waiver of the debt of £500,000 increased the value of the Rock Fall shares, but the B waiver of the debt, that is the expenditure, was not "on" the shares, nor was it reflected in "the state or nature of the asset", that is the shares "at the time of its disposal".

It was contended, third, that the Appellants' shares in Rock Fall and their loan to Rock Fall had been merged and that the value of the asset sold, that is the shares, was derived, at least in part, from the loan and its waiver and that C in terms of para 8 of Sch 6 to the 1965 Act, a proportion should be attributable to the disposal of the shares. The answer to this contention is that the shares and the loan were never merged and indeed it is difficult to see how such disparate assets could ever be merged. The shares, at the date of this disposal, were the shares as they were at the date of their issue and nothing had been added to them by the loans. What the loan, or rather the waiver of the loan, did, was to add to D their value, but that, in my opinion, is not a merger within the paragraph.

For these reasons I concur with your Lordships and answer the question in the negative and would dismiss the appeal.

Lord Avonside—Your Lordship has set out the facts in this case and they require no repetition. On 16 March 1971 Westminster offered to purchase the whole issued share capital of Rock Fall for the sum of £250,000, subject to E certain conditions, the first of which was that the holding company, Aberdeen, should waive the loan by them to Rock Fall, which at that date stood at £500,000. The transaction went through, the loan being waived and the Rock Fall shares transferred to Westminster. Aberdeen was assessed to corporation tax in an amount of £10,000 for the period ending 31 December 1971. They appealed to the Special Commissioners and, this appeal having failed, have now come to F this Court.

The primary argument for the taxpayers, as expressed by the Dean of Faculty, was that the sum of £250,000 was not paid wholly for the acquisition of the Rock Fall shares. Put simply, he argued that that sum was paid partly for the acquisition of shares and partly for the waiver of the Aberdeen loan; that there should be an apportionment, quoting Sch 6, para 8, to the 1965 Act; that in G such an apportionment the consideration of the shares should be taken as nil since the others were worthless unless the loan was waived. It is most unfortunate that we do not have the opinion of the Commissioners on this point. That was because they were in error in applying the provisions of s 56 of and para 10 of Sch 10 to the Finance Act 1971 to the transaction. In fact, looking to the dates of the transactions and the Act, that Act had no application to the matter before H them.

The sale and purchase of the Rock Fall shares involved a tripartite agreement. Aberdeen had to waive its debt and Westminster paid £250,000 and obtained the Rock Fall shares. On the facts found there is no ground, in my opinion, to support the primary submission. On the information in the case

(Lord Avonside)

Westminster wanted to purchase the Rock Fall shares and offered £250,000 for them provided, *inter alia*, that the Aberdeen loan was waived. There is no suggestion that, as part of the bargain, Westminster would recoup Aberdeen for its loan to the extent of £250,000 or to any extent. If Aberdeen waived the debt, which they did, Westminster would purchase Rock Fall shares at a price of £250,000 which they did. I cannot elaborate on that. In my opinion the major argument for the taxpayer fails. A B

The Dean of Faculty presented other arguments which he candidly said were subsidiary. The first argument was based on para 4(1)(*b*) of Sch 6 and, put shortly, was that the loan by Aberdeen to Rock Fall was expenditure wholly and exclusively incurred on an asset—the shares in Rock Fall—for the purpose of enhancing the value of the shares, being expenditure reflected in the state or nature of that asset at the time of its disposal. I am content to follow the reasoning of the Commissioners. The sum of £500,000 was a loan, not expenditure. It was not wholly and exclusively incurred on the shares. It may have enhanced their value in so far as it might give Rock Fall working capital helpful to its trading. When the loan was waived the shares remained in their state and nature unchanged. Accordingly, in my opinion, this argument fails. C

It was next argued that the provisions of para 8 of the Schedule applied and a proportional computation had to be made on disposal. It was said that the two assets, the loan of £500,000 and the share capital of Rock Fall, had been "merged". I cannot accept this proposition. The reality of the situation was that a loan had been made by Aberdeen to Rock Fall. Rock Fall shares still existed in their original form. The loan would appear in the Company's balance sheet as a loan. I am unable to see how these two assets merged and so reject this argument. D E

Finally, it was argued that the loan of £500,000 was a "debt on a security (as defined in paragraph 5 of this Schedule)". I am quoting from para 11(1) of Sch 7. When one looks at the definition of "security" contained in para 5(3)(*b*) it is to my mind plain that the creditor in such a debt must be issued some kind of "voucher"—I use the word neutrally—which acknowledges the debt on which it is charged. In this case it is perfectly true to say that at any time they wished Aberdeen could have made their loan of £500,000 a debt on a security. They wholly owned Rock Fall and could have, for example, issued debentures against the £500,000 or adopted various different means of creating a debt on a security. But the simple fact is that they did not do so. The loan throughout its existence was a simple loan and the question of charge does not arise. F

I would dismiss the appeal. G

Appeal dismissed.

The Company having appealed against the above decision, the case came before the House of Lords (Lord Wilberforce, Viscount Dilhorne and Lords Fraser of Tullybelton, Russell of Killowen and Keith of Kinkel) on 11 and 12 January 1978, when judgment was reserved. On 15 February 1978 judgment was given against the Crown, with costs (Viscount Dilhorne and Lord Russell of Killowen dissenting). H

A *The Dean of Faculty* (*J. P. H. Mackay Q.C.*) and *R. D. Mackay* for the Company.

W. D. Prosser Q.C. and *J. A. D. Hope* for the Crown.

The case cited in argument is referred to in Lord Wilberforce's speech.

Lord Wilberforce—My Lords, this appeal concerns the application of B certain provisions of the Finance Act 1965 relating to capital gains tax. The actual tax assessment which is in issue is for corporation tax for the Appellants' accounting period ended 31 December 1971, but this depends on whether the Appellants in that period incurred a chargeable gain.

The Appellants at the relevant time were a holding company with interests in a number of other companies. One such company was Rock Fall Co. Ltd. C Rock Fall was formed in 1957 to carry on specialist work involving drilling and blasting of rock. It was successful, but was short of the capital needed to acquire expensive equipment. The Appellants were customers of Rock Fall. In June 1960 they decided to take an interest in that company; they subscribed for 4,600 shares at par and made a loan to it. In February 1961 the Appellants acquired its remaining issued share capital—35,400 shares—so that Rock Fall D became a wholly owned subsidiary. Later the issued capital of Rock Fall was increased to 125,000 shares, the Appellants subscribing the newly issued shares at par. In all, the Appellants spent £114,024 for the shares in Rock Fall purchased and subscribed for.

Rock Fall's business expanded in the 1960s and needed more money for plant and working capital. Its requirements were met through unsecured loans E from the Appellants. At 31 December 1970 these loans totalled £500,000 and were shown at this figure in the Appellants' balance sheet under the heading Capital Employed—Loan. Thus the Appellants' total investment in Rock Fall amounted to £614,024. With the prospect of having to provide further capital if the interest in Rock Fall were to be retained, the Appellants decided to seek a purchaser for Rock Fall and in 1971 entered into negotiations and ultimately F an agreement with Bos Kalis Westminster Dredging Group N.V. ("Westminster"). The agreement was recorded in a letter dated 10 March 1971 from Westminster to the Appellants, the terms of which the Appellants accepted. It is necessary to reproduce this in full:

"Dear Sirs, We hereby offer on behalf of Westminster Dredging Group Ltd., subject to the undernoted conditions to purchase the whole issued G share capital of Rock Fall Co. Ltd. of Barrhead, Scotland, for the sum of £250,000. The conditions are: 1. Aberdeen Construction Group Ltd. waive the loan to Rock Fall Co. Ltd. which presently stands at £500,000. 2. Taxation losses accumulated as at this date remain for the benefit of the purchaser. 3. Net Current Assets of £58,732 as shown in the draft Balance Sheet as at 31st December 1970 which is attached and initialled by repre- H sentatives of both companies are guaranteed by the Vendors. Any variation in the said sum shall be made good by the Vendors or paid over by the

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Purchaser as at 31st December 1971 without any adjustment for interest. The said sum of £250,000 is due and payable as at 10th April 1971. Notwithstanding the date hereof the effective date of transfer of the shares is to be at 31st December 1970, and the Vendors will procure that the transfer of the shares will be properly effected into such names as will be notified." A

In accordance with this the Appellants wrote off the loan of £500,000 in their balance sheet as at 31 December 1970. Thus, in financial or economic terms, the result of the Appellants' "investment" in Rock Fall turned out as follows: B

	£
Cost of shares bought and subscribed for	114,024
Loan written off	500,000
	614,024
Proceeds of disposal of shares	250,000
	364,024

C

The Appellants debited this amount to capital reserve in their balance sheet at 31 December 1970. In this situation it may seem surprising that any question should arise of the Appellants having to pay tax on the basis of a capital gain. They had made an unfortunate investment. They had lost £364,024. But the Crown contend that the Appellants made a chargeable gain on the disposal of the shares in Rock Fall of £135,976, representing the difference between £250,000 received under the agreement of 10 March 1971 and £114,024, the cost of the shares. Again it seems surprising that the shares in Rock Fall should have appreciated to such an extent after their acquisition by the Appellants, and in the light of Rock Fall's balance sheet as at 31 December 1970, which showed net current assets of only £58,732. D E

The capital gains tax is of comparatively recent origin. The legislation imposing it, mainly the Finance Act 1965, is necessarily complicated, and the detailed provisions, as they affect this or any other case, must of course be looked at with care. But a guiding principle must underlie any interpretation of the Act, namely, that its purpose is to tax capital gains and to make allowance for capital losses, each of which ought to be arrived at upon normal business principles. No doubt anomalies may occur, but in straightforward situations, such as this, the courts should hesitate before accepting results which are paradoxical and contrary to business sense. To paraphrase a famous cliche, the capital gains tax is a tax upon gains: it is not a tax upon arithmetical differences. F G

The business reality of the present case is that the Appellants made an investment in Rock Fall—the word "investment" is not mine but is that used by the Special Commissioners: "Aberdeen's investment in Rock Fall amounted to £614,024." This took the form partly of subscription of share capital (plus a small amount for purchase of shares), partly of a loan. Whichever it was represented capital made available to Rock Fall: in Rock Fall's draft balance sheet as at 31 December 1970 there was shown under a heading "Capital Employed" first the share capital (£125,000), secondly the loan (£500,000). Those managing the affairs of the Appellants would undoubtedly consider any proposition to "get out" of Rock Fall in the light of this total investment: when they had done so—and obtained £250,000 from Westminster—they so recorded the result in their balance sheet. It is clear however that the capital H I

(Lord Wilberforce)

A gains tax legislation prevents the matter being looked at in so simple a manner as this because it imposes the tax on disposals of "assets" (Finance Act 1965, s 19). So it is necessary to consider separately each asset disposed of in the light of rules which apply to that asset. The asset on which, on the Crown's claim, the chargeable gain was made was the shares in Rock Fall owned by the Appellants. There is no doubt that these shares were acquired for £114,024 B but for what were they disposed of? The answer to this question must be found in the contract of 10 March 1971, interpreted, as any contract must be, against its background. At 10 March 1971, on the basis of Rock Fall's draft balance sheet at 31 December 1970, the Rock Fall shares had little or no value: certainly they could not be worth par; still more certainly they could not be worth £2 each, a value they would have to possess if a price of £250,000 was to be justified. C On the other hand, if the debt of £500,000 were to be removed the position would be very different: there would be tangible assets and tax losses which might well be of considerable value to a purchaser. The agreement of 10 March 1971 is drafted so as to deal with this situation; it does so by para 1, "Aberdeen waive the loan". I can only read this as a contractual provision to be performed by the sellers of the shares: in other words, leaving aside the subsidiary matters D dealt with in the other clauses, the contract is that (1) the Appellants shall transfer the shares and waive the loan, (2) Westminster will pay £250,000. The effect of this is that Westminster was paying £250,000 not only for the shares, but for the composite obligation undertaken by the Appellants. If this is right, in order to ascertain what Westminster was paying and the Appellants receiving for their shares, an apportionment would have to be made of the sum of £250,000 E between these two obligations.

The argument for the Crown that £250,000 was paid for the shares alone was based, in the end, as I understand it, on the use of the word "conditions". The contract was, so they contend, for the shares, but the agreement to buy at the stated price was conditional upon the waiver of the loan. The waiver was something which was to be carried out before the sale and independently of it, F in order to clear the way for a sale at £250,000. I cannot accept this. An obligation may be, or be called, a condition and still be a contractual term. Calling a term a condition, so far from making it non-contractual, normally makes it a contractual term of particular importance—such that if it is not carried out the other party may rescind the contract. It is clear that the loan had not been waived at the date of the contract—para 1 states that it "presently stands at G £500,000". It is equally clear that in order to bring into force Westminster's obligation to pay £250,000, the Appellants would have not only to transfer the shares but to waive the loan: from this it must follow that the £250,000 was paid in consideration of both obligations. On this I must respectfully differ from the learned Judges of the Court of Session. The Lord President (Emslie) held that there were two separate disposals by the Appellants but only one of them a H disposal to Westminster. Westminster contracted to acquire the rights of the Appellants as shareholder and that is what they paid for. "So far as the loans are concerned the Appellants waived them in a question with Rock Fall in order to be able to sell the shares to Westminster(1)." But the question, as I see it, is not whether there was a "disposal" to Westminster of the debt, but—a pure matter of contract—what the £250,000 was paid for. In this context the I fact is that the Appellants agreed *with Westminster* to waive the loan to Rock Fall. A may quite well agree with B to release C from an obligation, thus giving

(1) Page 291 *ante*.

(Lord Wilberforce)

rise to a contract between A and B: this is what the Appellants did. If the Appellants failed to waive the loan, Westminster would be entitled to force them to do so, or at least to recover damages. I would therefore so far allow the appeal and remit the matter to the Special Commissioners to make an apportionment as suggested above and to adjust the assessment accordingly. A

The Appellants then raised a further contention—which in fact appears first in their submissions before the Special Commissioners—that is that the Appellants disposed both of the shares and of the loan, each of which were "assets", for an aggregate sum of £250,000, and that for corporation tax and capital gains tax purposes the Appellant made a loss of £364,024. That the shares and the loan were "assets" is not disputed, but it is said that any loss on the loan cannot be treated as a loss for capital gains tax purposes because of certain special provisions in the Finance Act 1965. This raises a difficult question. That a debt is an "asset" is expressly stated in s 22(1)(*a*) and that a release or extinction of a debt is a disposal of an asset appears from ss 22(3)(*c*) and 23(3). However, whether such a disposal gives rise to a chargeable gain or an allowable loss (these are governed by the same rules, see s 23(1)) depends upon provisions in Schs 6 and 7. The Crown claims that the disposal of this debt is prevented from giving rise to a gain (or a loss) by Sch 7, para 11(1), which, as between the original debtor and creditor, does so prevent "except in the case of the (sic) debt on a security (as defined in paragraph 5 of this Schedule)". Reference to para 5 plunges us at once into a thicket. The relevant paragraph is 5(3)(*b*) which reads: B C D

> " 'security' includes any loan stock or similar security whether of the Government of the United Kingdom or of any other government, or of any public or local authority in the United Kingdom or elsewhere, or of any company, and whether secured or unsecured." E

This raises several difficulties. First, the sub-paragraph does not provide a definition except by inclusion, so the question must arise whether the reference in para 11 is limited to what is specifically mentioned as included, or to some wider class. Second, if it defines anything, it defines "security" not "debt on a security", and in view of the words "whether secured or unsecured" the latter must include some unsecured debts. As Lord Cameron said in *Cleveleys Investment Trust Co.* v. *Commissioners of Inland Revenue*(1) "whatever else it may mean, the phrase 'the debt on a security' is not a synonym for a secured debt.": 1971 SC 233, at page 244. But which unsecured debts come within the exclusion in para 11 and which do not is not stated and I find it impossible to discover any principle on which to state a discrimen. F G

The general subject of company indebtedness, or of loans to companies seems to be one as to which the legislative mind is clouded. The courts have had difficulties over the subject of "funded debt" as to which this House felt obliged to differ from the Court of Appeal (*Reed International Ltd.* v. *Commissioners of Inland Revenue*(2) [1976] AC 336). They have had difficulties over "loan capital" and "issue of loan capital" (*Agricultural Mortgage Corporation* v. *Commissioners of Inland Revenue*(3) [1978] 1 All ER 248 (CA)). In that case money was borrowed by the company for capital purposes, the purpose being to enable it to make loans to other persons. The members of the Court thought that the money borrowed had the character of loan capital. "The money was H

(1) 47 TC 300, at p 318. (2) L (SD) 63. (3) L (SD) 67; [1978] 2 WLR 230.

A required for capital purposes; and it was borrowed money" (*per* Scarman L.J., at page 264[1]). But they did not consider that there had been an "issue". The decisions were on different statutes *inter se* and from the Finance Act 1965 and it is difficult to find any clear common principle underlying them, but taking such guidance as they do provide leads me to think that the only basis on which a distinction can be drawn is between a pure unsecured debt as between B the original borrower and lender on the one hand and a debt (which may be unsecured) which has, if not a marketable character, at least such characteristics as enable it to be dealt in and if necessary converted into shares or other securities. This is indeed lacking in precision but no more can be drawn from the statutory provisions than the draftsmen have put in—and that is both meagre and confusing. In agreement with the Court of Session I can find C nothing here except an unsecured loan subsisting as between the original debtor and creditor given the description of loan capital, whether correctly or not, but with no quality or characteristic which brings it within whatever special category is meant by debt on a security. I cannot therefore accept this argument.

A final contention of the Appellants was based upon Sch 6, para 8, of the D Finance Act 1965, an obscure provision dealing with merger of assets and similar situations. I agree with the Court of Session that this contention is a hopeless one and need add nothing to their reasons.

To the extent indicated I would allow the appeal.

Viscount Dilhorne—My Lords, the Appellants invested £614,024 in a company called Rock Fall Co. Ltd., £114,024 of which was applied to the purchase E of the issued share capital of that company and the balance, £500,000, was by way of loan. The Appellants accepted an offer by the Bos Kalis Westminster Dredging Group N.V. ("Westminster") to purchase the shares they held in Rock Fall for £250,000 subject to certain conditions, one of which was that the Appellants should waive their loan for £500,000 to Rock Fall. The result was that the Appellants suffered a loss of £364,024 on their investment. There is no F doubt about that and no doubt that the transaction was a perfectly genuine one not designed or intended to avoid or to evade capital gains tax. Nevertheless the Crown has sought, despite the Appellants' actual loss, to establish that they made a capital gain of £135,976 on the sale of the shares which was liable to tax. If part of the sum paid by Westminster was attributable to the waiving of the loan by the Appellants, then the Crown is not entitled to succeed in full G on its claim; the £250,000 must be apportioned between the waiver of the loan and the shares with the probable result that there will then be no liability to capital gains tax. The Appellants raised a number of points. I have had the advantage of reading the speeches of my noble and learned friends Lord Wilberforce and Lord Russell of Killowen. They agree on all points save one, and I agree with and have nothing to add to what they say on those on which H they agree.

The question on which they differ is whether any part of the price paid by Westminster is to be attributed to the waiver of the loan. The contract made between the Appellants and Westminster was made by the acceptance by them of an offer made by Westminster in a letter. If Westminster had asked the

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(1) L (SD) 67, at p 25.

(Viscount Dilhorne)

Appellants to assign the loan to them, part of the purchase price would no doubt have been attributable to that. But Westminster did not ask for that and apparently the Appellants did not suggest it. The offer contained in the letter was "Subject to the undernoted conditions to purchase the whole issued share capital of Rock Fall Co. Ltd. . . . for the sum of £250,000." There were five conditions, the first two of which ran as follows: "1. Aberdeen Construction Group Ltd. waive the loan to Rock Fall Co. Ltd. which presently stands at £500,000. 2. Taxation losses accumulated as at this date remain for the benefit of the purchaser." The third condition provided for payment if there was any variation in the net current assets as shown in the draft balance sheet as at 31 December 1970; the fourth that the £250,000 should be due and payable as at 10 April 1971; and the fifth that the effective date of transfer of the shares should be 31 December 1970. The offer was expressed to be one to buy the whole issued share capital of Rock Fall for £250,000 and it would in my view be wrong to interpret it as including an offer to pay a part of that sum for the waiver of the loan. Just as a man may offer to buy a second-hand motor car for £X on condition that it passes its M.O.T. test or offer to buy a house for a certain sum if certain repairs or alterations are made without agreeing to pay any sum towards the expense of the test or for the repairs or alterations, so here, in my opinion, it is not right, having regard to the terms of the letter, to conclude that Westminster had agreed to pay for the waiver and so to attribute any part of the price to the obtaining of the waiver. If apportionment of the price of £250,000 between the issued share capital and for the waiver was justifiable in this case, why should the apportionment be limited to those items? Taxation losses were to remain for the benefit of Westminster. Presumably they were of value to Westminster for otherwise that would not have been made a condition of the contract. If they were of value and any apportionment is justified, I can see no reason for limiting it to apportionment to the waiver. Some of it surely would be attributable to the acquisition by Westminster of the taxation losses. It is not open to us to re-write the bargain made between the parties, and I do not think it is right to hold that part of the £250,000 was paid for the waiver when the letter states that that price was to be paid for the issued share capital and does not state that it was to be paid for anything else. If that conclusion is reached I think it would have also to be held that part was also paid for the acquisition of the taxation losses.

For these reasons, and for the reasons stated by him, I agree with the conclusion reached on this by my noble and learned friend Lord Russell of Killowen. I have reached this conclusion with regret for it means, if effect were to be given to it, that under the capital gains tax legislation, for the form of which the Inland Revenue have no doubt some responsibility, an actual and genuine loss can be treated as containing a profit liable to tax. We were told that other cases depended on the result of this case. That appears to me to depend on whether the contracts made were in the same or similar terms.

I would dismiss the appeal.

Lord Fraser of Tullybelton—My Lords, the Appellants, to whom I shall refer as "Aberdeen", were at the date of the transaction to which this appeal relates a holding company. One of their wholly-owned subsidiaries was Rock Fall Co. Ltd. ("Rock Fall"). Aberdeen not only held all shares in Rock Fall but they had also made large loans to it. The appeal is concerned with the question whether a loss incurred in writing off the loans is an allowable loss for the purposes of computing Aberdeen's capital gains as an element in its liability to corporation tax.

A Aberdeen had acquired the shares in Rock Fall and made the loans over a period of about ten years, starting in June 1960. Some of the shares were acquired by purchase, but most of them were subscribed for by Aberdeen at par as Rock Fall's issued capital was increased to enable it to purchase the very expensive equipment needed for its business of underwater drilling and blasting. By the end of 1970 the total cost of the shares was £114,024 and the B total amount of the loans was £500,000, making a total investment by Aberdeen in Rock Fall of £614,024. During 1970 Rock Fall's trading position deteriotated and Aberdeen sought a purchaser for Rock Fall. By letter dated 10 March 1971 an offer was made by Bos Kalis Westminster Dredging Group N.V. ("Westminster") to purchase from Aberdeen for the sum of £250,000 the whole issued share capital of Rock Fall on condition, *inter alia*, that Aberdeen would waive C its loan to Rock Fall. Aberdeen accepted the offer and thereafter they wrote off the loan and transferred the shares to Westminster. The effect of the contract therefore was that Aberdeen lost the difference between the amount of its investment, £614,024, and the purchase price, £250,000, namely, £364,024. That is the reality. Nevertheless the Crown claims that for the purposes of capital gains tax Aberdeen have made a capital gain of £135,976 because the D shares in Rock Fall which had cost £114,024 were sold for £250,000, giving a profit of £135,976. This claim has been upheld by the Special Commissioners of Income Tax and, on appeal, by the First Division of the Court of Session, essentially because they held that the sum paid by Westminster was paid for the shares alone and that it was not permissible under the relevant legislation to take into account the loss on the loan. The appeal arises on Aberdeen's E assessment to corporation tax for the accounting period ended on 31 December 1971. The treatment of its loan to Rock Fall has been taken as a test case and will govern the treatment of other loans by Aberdeen. The primary argument for Aberdeen was that the sum of £250,000 paid by Westminster was not paid only as consideration for the transfer of the shares but was also partly for waiver of the loan. This argument was not considered on its merits by the Special Com- F missioners because they thought that it was excluded by s 56 and para 10 of Sch 10 to the Finance Act 1971. In that they were mistaken because, as the Crown concedes, the 1971 Act was not in force at the relevant time. In the First Division the argument was considered but it was rejected by all three members of the Court, and the first question for decision is whether it was rightly rejected. The question falls to be answered by reference to the terms of the G contract between Aberdeen and Westminster as set out in the letter of 10 March 1971. That letter was as follows:

"We hereby offer on behalf of Westminster Dredging Group Ltd., subject to the undernoted conditions to purchase the whole issued share capital of Rock Fall Co. Ltd., of Barrhead, Scotland, for the sum of £250,000. The conditions are: 1. Aberdeen Construction Group Ltd. H waive the loan to Rock Fall Co. Ltd. which presently stands at £500,000. 2. Taxation losses accumulated as at this date remain for the benefit of the purchaser. 3. Net Current Assets of £58,732 as shown in the draft Balance Sheet as at 31st December 1970 which is attached and initialled by representatives of both companies are guaranteed by the Vendors. Any variation in the said sum shall be made good by the Vendors or paid I over by the Purchaser as at 31st December 1971 without any adjustment for interest. 4. The said sum of £250,000 is due and payable as at 10th April 1971. 5. Notwithstanding the date hereof the effective date of transfer of the shares is to be at 31st December 1970, and the Vendors will procure that the

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> transfer of the shares will be properly effected into such names as will be notified." A

The effect of the letter must in my opinion be ascertained in accordance with the ordinary principles of construction and not by looking at it specially from the point of view of Aberdeen as a taxpayer with a possible liability for capital gains tax.

The first paragraph of the letter containing an offer "to purchase the whole issued share capital of Rock Fall" is the basis of the case for the Crown. If that paragraph stood alone, there could be no doubt that the sum of £250,000 was paid as consideration for the transfer of the shares and for nothing else, as indeed the learned Judges of the First Division have held. But it does not stand alone. It is followed by five conditions to which due weight must be given in determining the effect of the contract. The letter must be read as a whole. The most important condition for the present purpose is condition 1, by which Aberdeen became obliged to waive the loan to Rock Fall. Clearly this was an obligation to be implemented at a future date, for the condition bears that the loan "presently stands" at £500,000. Accordingly the contract as set out in the first paragraph and in condition 1 (disregarding the other conditions for the moment) was that in return for the sum to be paid by Westminster Aberdeen undertook to do two things; (1) to transfer to Westminster the whole issued share capital of Rock Fall and (2) to waive its loan to Rock Fall. The negotiations between Westminster and Aberdeen were, as the Special Commissioners have found, conducted at arm's length, and there is therefore no question of either of Aberdeen's obligations having been undertaken gratuitously. The result is, in my opinion, that part of the consideration ought to be apportioned to each of the obligations. I do not consider that the same argument applies to the other conditions of the offer. They are entirely different in character from condition 1. Conditions 2 and 3 are both concerned with preserving the assets of Rock Fall as they were at the effective date of transfer or with providing for compensation for any variation in favour of either party, whereas condition 1 imposed an onerous new obligation on the seller. Conditions 4 and 5 are merely regulating administrative details. The shares and the loan were separate assets both belonging to Aberdeen, but it is obvious that the value of the shares was greatly affected by the existence of the loan. In fact the shares were virtually worthless so long as the loan of £500,000 remained in existence, ranking, as of course it did, ahead of the shares. The view that has so far prevailed is that what Westminster purchased was in substance the shares in a company after its loan capital had been waived, or shares in a debt-free company, but I do not think that that view is correct. There was no stipulation that the loan was to be waived before the shares were transferred and there was, so far as I can see, no necessity, either legal or practical, for the two steps to be taken in that order. The contract was not for the purchase of shares in a company whose loan capital had already been extinguished, but was for the purchase of shares on condition that the seller also undertook to extinguish the loan. That is in my opinion the effect of condition 1, and it is to some extent confirmed by other conditions. Condition 5 provides for the effective date of transfer of shares to be 31 December 1970 and at that date the loan of £500,000 was, of course, in existence. Condition 3 provides for the net current assets of £58,732 "as shown in the draft balance sheet as at 31st December 1970" to be guaranteed by Aberdeen, and that draft balance sheet also showed the loan capital of £500,000 which must have been one of the elements taken into account in arriving at the amount of the net current assets. The waiver of the loan was therefore something required in implement of the contract in exchange for the

A payment of £250,000 by Westminster. It is, of course, true that there was no question of comparing an offer from Westminster to purchase the shares while the loan remained outstanding at a price of £X with an alternative offer to purchase the shares after waiver of the loan at a price of £X + £Y. No doubt the reason was that the amount of the loan was so large that the value of X in that example would never have been more than minimal. If that is right, the B inference seems to be that the consideration must have been wholly or mainly paid for the waiver of the loan. I think it was.

One of the reasons that weighed with the Lord President (Emslie) in coming to the opposite conclusion was that, although there were two disposals, only one of them, the disposal of the shares, was to Westminster. The loan was disposed of by waiver in favour of Rock Fall, and Westminster neither wanted C nor acquired Aberdeen's rights as creditor of Rock Fall. I agree that that is so, but it does not in my opinion support that conclusion reached by the learned Judge. The direct benefit from waiver of the loan would accrue to Rock Fall, but it is evident that benefit would also accrue indirectly to Westminster if it became owner of the whole share capital of Rock Fall; if Westminster had not considered that waiver of the loan would be beneficial to itself, it would pre- D sumably not have made waiver a condition of the contract. At the end of the day, when the whole transaction was complete, the benefit to Westminster would of course be reflected in the value of its shares in Rock Fall. But at the time when the contract was made, the two steps of transfer and waiver had to be taken by Aberdeen and it seems to me that part of the consideration (probably much the greater part of it) must have been attributable to the waiver, because E it is inconceivable that a sum approaching £250,000 would have been paid as consideration for transfer of the shares unaccompanied by the waiver. For these reasons I am of opinion that the sum of £250,000 received by Aberdeen from Westminster consisted partly of consideration for the waiver of the loan to Rock Fall and that it ought to be apportioned accordingly. Apportionment is a matter for the Special Commissioners under the Finance Act 1965, Sch 6, F para 21(4), and it is therefore necessary that the case be remitted to them to apply such method of apportionment as appears to them to be just and reasonable. I would remit the case accordingly.

The result of such apportionment will not relieve Aberdeen of its whole liability for capital gains tax in respect of this transaction unless a further question is answered in their favour. The apportionment would enable Aberdeen G to show that they had made a loss on disposal of the asset consisting of its shares in Rock Fall, the amount of the loss being the difference between the cost of that asset (£114,024) and such part, if any, of the sum of £250,000 as might be apportioned to that asset by the Special Commissioners. There is no question that that loss would be an allowable loss for capital gains tax under Part III of the Finance Act 1965. Section 19 of the Act, which is the main H charging section, and s 22, which defines assets and disposals for the purposes of capital gains tax, refer only to gains, but the same rules apply for computing allowable losses—see s 23. There is no doubt that the loan to Rock Fall was an "asset" of Aberdeen in the sense of s 22(1)(*a*), nor that its waiver in consideration of a capital sum was a "disposal" in the sense of s 22(3)(*c*). But the question is whether the resulting loss to Aberdeen is an allowable loss for the I purposes of capital gains tax. Schedule 7, paras 11 and 5, provide in effect that no chargeable gain or allowable loss shall accrue to the original creditor in a debt except in the case of a "debt on a security". For the reasons given by the

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learned Judges of the First Division and by my noble and learned friends, Lord Wilberforce and Lord Russell of Killowen, I find it impossible to say that Aberdeen's loan to Rock Fall was a debt "on a security", whatever the exact meaning of the expression may be. It follows therefore that I agree that any loss on the loan is not an allowable loss for the purposes of capital gains tax. I also agree that the Appellants' argument founded upon the terms of para 8 of Sch 6 to the Act of 1965 is unsound in respect that there was no merger of assets in this case. A B

For these reasons I would answer the question of law in the affirmative and I would remit the case to the Special Commissioners to apportion the consideration between the shares and the loan.

Lord Russell of Killowen—My Lords, on the first point taken by the Appellants it is in my view necessary to consider the contract between Westminster and the Appellants without looking over the shoulder at the statutory provisions relating to capital gains tax. The contract was, it appears to me, a contract by Westminster to buy from the Appellants the issued share capital of Rock Fall and to pay as consideration for its transfer £250,000. This is after all what the contract says. The obligation to pay that sum for the shares was conditional upon the shares being shares in a company not burdened with a debt of £500,000 owing to the Appellants and the consideration for the shares was based upon that assumption, but it was and remained consideration only for the shares. Westminster might of course have agreed to pay £250,000 for transfer of the shares and assignment to it of the debt: but that was not the method which the parties chose to adopt for the transaction. (It has before now been said in this House, in the fiscal context of estate duty, "While mere form may not be a deciding factor in the incidence of estate duty, methods adopted may be." In re *Kirkwood* [1966] AC 520, at pages 545, 548 and 551.) There was never a contract to pay £250,000 (*a*) for shares in a relevantly indebted company and (*b*) for a waiver of the relevant debt: that concept appears to me artificial: it is to my mind unrealistic to suppose, on the form of the contract, that there was to be any obligation on Westminster to pay anything unless and until Rock Fall no longer owed a debt to the Appellants, in which event the payment was to be only for the shares. It is I believe agreed on all hands that if Westminster had said to the Appellants, "I am not interested in the Rock Fall shares while your debt remains outstanding: go away and extinguish it and I will then bid you £250,000 for the shares", the Appellants' first point could not have succeeded. The distinction between that situation and a contract such as was made, viz: to buy the shares for £250,000 on condition the debt be extinguished, is too fine for me to appreciate. Recognition of the distinction, I think, with respect, stems from an understandable reluctance to hold that the ambush of this legislation should catch the Appellants with a taxable capital gain when it has lost a substantial sum by its unhappy venture in Rock Fall. Accordingly I would decide against the Appellants on their first contention. C D E F G H

The second contention of the Appellants is based upon para 8 of Sch 6 to the Finance Act 1965, which contention if correct would lead to some apportionment, as under the first contention. That paragraph is cross-headed "Assets derived from other assets". If broad terms were legitimate in connection with any part of this complicated legislation one would say that in broad terms the paragraph is designed to provide for computation of capital gains where one asset has gained in value at the expense of another asset in the same ownership. Had it been expressed in such broad terms it would be clear that in the I

A circumstances the Rock Fall shares asset had gained in value by the extinction of the Appellants' other asset—the debt. But the paragraph has limiting factors or qualifying conditions for its operation. So far as presently relevant it was necessary for the Appellants to contend that the debt and the shares had been "merged" or (perhaps) that the shares had "changed their nature". I find these contentions wholly unacceptable. Release of a company from its debt does not B achieve anything that can be described as merger of the debt with the shares in the company: nor does it change the nature of those shares. If the contrary were true it would equally be appropriate to say that (within the paragraph) the debt was a right or interest *over the shares* which had been extinguished: but of course it was not such. At one time I speculated whether it could be said that the waiver of the debt was a case of extinction of "rights or interests in or C over" the assets consisting of the debt—a suggestion quite rightly not advanced by Counsel for the Appellants. The speculation was soon terminated by Counsel for the Crown who pointed out that total extinction of the asset cannot come within the language: the part is not the whole. Accordingly I would reject the second contention.

I turn to the Appellants' third contention. This depends upon the applica- D tion to the facts of this case of the language of paras 11(1) and 5(3)(*b*) of Sch 7 to the Statute. Paragraph 11(1) is in the following terms:

> "Where a person incurs a debt to another, whether in sterling or in some other currency, no chargeable gain shall accrue to that (that is the original) creditor or his legatee on a disposal of the debt, except in the case of the debt on a security (as defined in paragraph 5 of this E Schedule)."

Paragraph 5(3)(*b*) is in the following terms:

> " 'security' includes any loan stock or similar security whether of the Government of the United Kingdom or of any other government, or of any public or local authority in the United Kingdom or elsewhere, or of any company, and whether secured or unsecured."

F I find these provisions particularly obscure and on any construction cannot find a rational explanation. There may be a temptation to take advantage of that very obscurity so as to reach a construction favourable to the stricken Appellants: but it must be borne in mind that the provision works both ways, and to find in this case an allowable loss is to find in another case a chargeable gain, though not perhaps of such hardship.

G Paragraph 11(1) deals with the disposal of a debt asset, but only where such disposal is made by the original creditor (or his legatee): such disposal might—for example in the case of a debt expressed in a foreign currency—result, on disposal by the original creditor (or his legatee), in a capital gain, but that gain is not to be a chargeable gain: and a parallel loss is not an allowable loss. But those provisions do not cover all debts, for there is excepted "the case H of the debt on a security (as defined in paragraph 5 of this Schedule)". (I do not know why "the debt": I take the phrase simply to mean "a debt", the language used in sub-para (2).) If the Appellants are to succeed on the third contention they must bring the £500,000 debt into the exception, the Appellants being the original creditor. In the ordinary sense of the phrase this cannot be said to be a debt on a security: it was not secured on any property or in any way. Can it be I said to be a debt "on a security" in the extended meaning given to the word "security" by para 5(3)(*b*)? That word embraces "any loan stock or similar

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security . . . of any company . . . whether secured or unsecured". Can it fairly be said that we have a case of "loan stock" or of a security "similar to loan stock"? The debt was of course a loan, or series of loans, to Rock Fall and figured in Rock Fall's balance sheet as such as one item under the head of "Capital Employed": this was a suitable accountancy niche having regard to the purposes for which the loans were made and to which they were put. But in my opinion this was not a case of loan stock, which suggests to my mind an obligation created by a company of an amount for issue to subscribers for the stock, having ordinarily terms for repayment with or without premium and for interest. The series of loans by the Appellants to Rock Fall ultimately in total outstanding amounting to £500,000 are not within that concept: nor can they fairly be described as "similar security". They were simply loans by Aberdeen, initially when Rock Fall was not a subsidiary and for the greater part when it was.

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Accordingly, for my part I reject the contentions of the Appellants under all three heads, and would dismiss the appeal. On a broader view of the circumstances of the case I am happy to find myself in a minority on the first point.

Lord Keith of Kinkel—My Lords, I agree with the speech of my noble and learned friend Lord Wilberforce, to which I cannot usefully add anything.

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I too would allow the appeal to the extent which he has proposed.

Appeal allowed, with costs.

[Solicitors:—Alex Morison & Co. W. S.; Solicitor of Inland Revenue (Scotland).]

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