HOUSE OF LORDS

SESSION 2004–05
4th REPORT
([2004] UKHL 52)

APPELLATE COMMITTEE

Her Majesty's Commissioners of Inland Revenue (Appellants)

v.

Scottish Provident Institution (Respondents) (Scotland)

REPORT

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4th REPORT

from the Appellate Committee

25 NOVEMBER 2004

Her Majesty's Commissioners of Inland Revenue (Appellants)
v.
Scottish Provident Institution (Respondents) (Scotland)

ORDERED TO REPORT

The Committee (Lord Nicholls of Birkenhead, Lord Steyn, Lord Hoffmann, Lord Hope of Craighead and Lord Walker of Gestingthorpe) have met and considered the cause *Her Majesty's Commissioners of Inland Revenue (Appellants) v. Scottish Provident Institution (Respondents) (Scotland)*. We have heard counsel on behalf of the appellants and respondents.

1. The following is the opinion of the Committee to which all its members have contributed.

2. This appeal concerns an artificial scheme devised in 1995 to take advantage of a prospective change in the system of taxing gains on options to buy or sell bonds and government securities ("gilts"). Under the legislation then in force, the Scottish Provident Institution ("SPI"), as a mutual life office, was not liable to corporation tax on any gain realised on the grant or disposal of such an option. Under the system proposed in an Inland Revenue consultation document published in May 1995, all returns on such options would be treated as income and losses made on disposals would be allowable as income losses.

The scheme in outline

3. The central element of the scheme devised by Citibank International plc ("Citibank") to enable SPI take advantage of the change-over was extremely simple. During the old regime, SPI would grant Citibank an option ("the Citibank option") to buy short-dated gilts, at a price representing a heavy discount from market price, in return for a correspondingly large premium. The premium received on the grant of the option would not be taxable. After the new regime came into force, Citibank would exercise the option. SPI would have to sell the gilts at well below market price and would suffer an allowable loss.

4. If that was all there was to the transaction, there would also have been a risk that SPI or Citibank would have made a real commercial profit or loss. The premium would have been fixed by reference to the current market price, but the possibility of a rise or fall in interest rates during the currency of the option created a commercial risk for one side or the other. Neither side wanted to incur such a risk. The purpose of the transaction was to create a tax loss, not a real loss or profit. The scheme therefore provided for Citibank's option to be matched by an option to buy the same amount of gilts ("the SPI option") granted by Citibank to SPI. Premium and option price were calculated to ensure that movements of money between Citibank and SPI added up to the same amount, less a relatively small sum for Citibank to retain as a fee. In addition, SPI agreed to pay Citibank a success fee if the scheme worked, calculated as a percentage of the tax saving.

5. The calculation of the SPI option price obviously needed careful thought. In one sense, of course, it did not matter. Whatever price was selected would be reflected in the corresponding premium and subsequent movements in the market price would cancel each other out. But the option price for SPI had to be higher than the option price for Citibank, otherwise the "profit" realised by SPI on the exercise of its option would cancel out the "loss" which it suffered on the exercise of the Citibank option and the whole exercise would be futile. Indeed, the greater the difference between the Citibank price and the SPI price, the greater would be the net tax loss

created by the scheme. The difference did give rise to a potential cash flow problem because, if Citibank paid the premium for its option, it would be out of pocket in respect of the difference between the two premiums between the date on which the options were granted and the date on which they were exercised. But this was covered by a collateral agreement under which SPI agreed to deposit the difference with Citibank, free of interest, until its option had been exercised or lapsed. This enabled the payment of both premiums to take the form of book entries.

6. On the other hand, the purpose of the SPI option was to reduce or eliminate the possibility that the outcome of the transaction would be affected by events in the real world such as movements in interest rates. So the SPI option price had to be sufficiently below market price as to be, for practical purposes, out of the possible range of such movements. There was also a third consideration. Plainly it was inconceivable that Citibank, having parted with a large premium for its option, would not exercise it. Equally, if the SPI price had been very low, it would have been inconceivable that SPI would not have countered by the exercise of its own option. That might have given rise to a doubt about whether in truth there was any transaction in gilts at all. It would have been inevitable that the obligations of Citibank and SPI to deliver gilts would cancel each other out and that none would change hands. So the SPI option price had to be close enough to the market price to allow for some possibility that this would not happen.

The scheme as implemented

7. The scheme was proposed by Ms Harrold of Citibank to Mr Burke, Group Taxation Manager of SPI, in a fax dated 22 June 1995. At that stage, it proposed option or "strike" prices of 95 and 70 (assuming market value on the trade date to be 100) respectively. The scheme as implemented used 90 and 70; a narrower spread which gave SPI a smaller tax loss but provided Citibank with greater security against a commercial loss. The way the scheme would work was explained with great clarity by Ms Harrold in a fax to Mr Paterson, Senior Corporate Manager of SPI, on 27 June 1995:

> "1. The company buys a nine month in-the-money Bermudan style call option contract which gives it the right but not the obligation to purchase 5 year gilts at a strike price of 90, in return for paying an up front premium.
>
> 2. The company sells a nine month in-the-money Bermudan style call option contract which gives Citibank the right but not the obligation to purchase 5 year gilts at a strike price of 70, in return for paying an up front premium.
>
> All options are to be settled for physical delivery. The strikes on the options are set at a level assuming that the value of the gilt is 100 on trade date. The style of the options is 'Bermudan' ie European for the first 2 months and American thereafter. Both options should be considered as qualifying 'financial options' for the purposes of taxation.
>
> *Expected taxation treatment*
>
> The premium received on the call option sold is treated as an exempt capital gain under the current tax regime. Drawing an analogy with the new financial instruments regime, it is conceivable that the premium paid on the option purchased may be added to the purchase price of the bonds when the option is exercised (since no relief has been obtained under the capital gains tax rules).
>
> After the date of commencement of the new legislation relating to the taxation of gilts and bonds ('commencement date'), the first call option is exercised by the company and immediately afterwards, Citibank exercises the second call option. The purchase and sale of the gilts under the options are netted down within the Central Gilts Office clearing accounts and therefore neither counterparty needs to take delivery of the gilts. The net of the two strikes is paid by the company to Citibank—in the example above 20.

> The loss on sale of the bonds is expected to be an income expense to the company under the new tax legislation and may be offset against other taxable income. This will be calculated as the sale proceeds of 70 less the cost of purchasing the bonds. If the premium on the option purchased is added to the cost of the bonds (see above), the net loss will be calculated as 30—ie 70 less the strike of 90 plus the option premium of 10. The amount of the loss available for offset should be at least the difference between the two strikes on the options—ie 90 less 70—in the case that the premium on the option purchased is not added to the cost of the bonds.
>
> *Collateralisation of premium paid by Citibank to the company*
>
> The cash paid to the company as the net of the two option premiums (20 in the above example) can be passed back to Citibank as collateral against the exposure to the company. If this cash collateral is interest free, this will enable the options to be priced as American style, ie with only intrinsic value and no time value. This means that no funding costs are borne by the company through the option pricing. The collateral is refundable when the option sold to Citibank is exercised, effectively neutralising the attractiveness of early exercise of the deep-in-the-money American style call option. At the same time, Citibank has cash collateral against its credit exposure to the company.
>
> The net option premium received by the company is the net intrinsic value of the options ie the difference between the two strikes (in our example, 20) and this is also the amount of the net cash which passes back to Citibank on exercise of both the options.
>
> Citibank NA is pleased to present to you the proposed transaction or transactions described herein. Under no circumstance is it to be considered as an offer to sell, or a solicitation to buy, any investment."

8. At a board meeting held in Dublin on 27 June 1995, SPI's board of directors decided to enter into the scheme as outlined in a paper prepared by the Group Actuary, Mr Gillon. The board minutes stated:

> "*Citibank: Cross Options Scheme*. The board received a paper. We were satisfied that we were running no risks other than the cost of the fixed fees involved (£100,000). The tax loss which would be established would be set against future capital gains (which would probably arise within the next few years). The announcement on which it all depended was expected to be made in July and implemented in the Finance Act 1996. There was perhaps only a 50-50 chance of it being successful (it was unlikely that we were the only people who had been approached). Part of the total fee to Citibank was deferred until it was confirmed that the scheme had been successful."

9. The formal documents were executed on 30 June 1995. Apart from an elaborate Master Agreement in the standard form produced by ISDA (the International Swaps Dealers Association) which neither side relied on, there were four essential documents: the "transaction A" option agreement (designated no 1224895), the "transaction B" option agreement (designated no 1224905), the collateral agreement and the fees letter. These documents contained some elaborate definitions and administrative provisions but their essentials were accurately summarised by the special commissioners (in sub paragraphs (7), (8), (10) and (11) of paragraph 5 of their written decision—sub paragraph (9) referred to the ISDA Master Agreement) as follows (but slightly amended to avoid repetition):

> "(i) Under transaction A, the taxpayer company granted a call option to Citibank in respect of £100m of nominal amount of 8% UK gilts due 7 December 2000 at an option strike price of 70% of the par value of the bond plus accrued

> interest. The option was exercisable at any time between 30 August 1995 and 1 April 1996. The premium for the option was £29.75m payable to the taxpayer company on 5 July 1995. Provision was made for notice of exercise of the option to be given. If the option were to be exercised, then settlement was to be 'physical' ie the bonds were to be delivered in exchange for payment.
>
> (ii) Under transaction B, Citibank granted a call option to the taxpayer company in respect of £100m of nominal amount of 8% UK gilts due 7 December 2000 at an option strike price of 90% of the par value of the bond plus accrued interest. The option was exercisable at any time between 30 August 1995 and 1 April 1996. The premium for the option was £9.81m payable by the taxpayer company on 5 July 1995. Provision was made for notice of exercise of the option to be given. If the option were to be exercised then settlement was to be 'physical', ie the bonds were to be delivered in exchange for payment.
>
> (iii) Under the collateral agreement, the taxpayer company [was] required to pay Citibank on 5 July 1995 the collateral amount, defined as "an amount of Pounds Sterling equal to the Bond Entitlement of Transaction A multiplied by the difference between the Option Strike Price of Transaction A and the Option Strike Price of Transaction B". This amounted to £20m. Under the agreement, it fell to be repaid, without interest, on the earlier of the day on which Transaction A was exercised and 1 April 1996.
>
> (iv) The [Structuring Fee Agreement] entitled Citibank to a structuring fee calculated by reference to the taxpayer company's long term business funds including and excluding the two option contracts, less the initial fee of £60,000, and subject to a maximum of £240,000. The maximum total fee was thus £300,000. The agreement provided for payment on 1 September 1996."

10. It will be apparent that the stated consideration for option A exceeded the stated consideration for option B by £60,000 less than £20m. The sum of £60,000 was Citibank's minimum fee, to be retained even if the scheme failed to save tax. The special commissioners accepted Ms Harrold's evidence that Citibank regarded the minimum fee as including the cost of hedging the risk Citibank was undertaking. The special commissioners also found (paragraph 5 (12)):

> "These option contracts created a genuine economic risk for Citibank. That risk was passed to Citibank, Frankfurt. Citibank, Frankfurt managed a pool of options to which the said two options were added. Citibank's bond option trading activities and risk management took place at Citibank, Frankfurt."

However, the £60,000 stayed in Citibank International plc. That appears from Ms Harrold's "booking summary" prepared on 3 July 1995. This document (written when the timing of the new legislation was still uncertain) repeated almost word for word what had been stated in the proposal sent to SPI on 27 June:

> "After the date of commencement of the new legislation relating to the taxation of gilts and bonds, the first call option is exercised by Scottish Provident and immediately afterwards Citibank exercises the second call option. The purchase and sale of the gilts under the options are netted down within the Central Gilts Office ("CGO") clearing accounts and therefore neither counterparty needs to take delivery of the gilts. The payment for the gilts on exercise of the options are also netted by the CGO."

11. On 12 July 1995 Mr Burke wrote an internal memorandum commenting on the Inland Revenue press release which had been put out two days before. The last date for exercise of the options was 1 April 1996, and it appeared from the press release that this was to be the date on which the new tax regime would start to apply to SPI. Mr Burke observed in his memorandum:

"The options themselves would also have to be exercised on 1 April 1996 in order to generate tax losses on the first day of the new rules. We will have to wait until the transitional rules are published to see if we have a chance of retaining these losses.

Holding the options until 1 April 1996 introduces two further issues: one for SPI and one for Citibank.

First, the options will be held over the year end and we will have to be satisfied that the accounting treatment, and disclosure, in the statutory accounts and returns does not have any adverse implications for either tax, or commercial purposes.

Second, we are extending the period over which there is a potential investment risk for Citibank. If the price of the underlying gilt drops below 90% of its nominal value SPI begin to make a profit on the arrangement. This is because the cost of satisfying SPI's obligation under the option we have written is less than the net premium received. Ultimately, the profit could be £20m in the extreme case where the price of the underlying gilt drops below 70% of its nominal value."

12. There are no further relevant documents before the House until a letter which Mr Paterson wrote to Ms Harrold on 20 March 1996, as follows:

"This is to let you know that we presently expect to exercise our option under transaction B on 1 April 1996. This is not formal notice of such exercise except in the circumstances considered in the third paragraph below. However, it may facilitate settlement to discuss consequences now.

If, as seems likely, the option under transaction A is also exercised (by Citibank) on 1 April 1996, I would suggest that we agree in terms of section 2 (c) of the ISDA Master Agreement that stock deliveries and all sums due (including the £20m collateral deposit under transaction A) be netted off for settlement purposes. The result would be that neither stock not money would be exchanged between us.

In the absence of our further instructions otherwise, please note that if Citibank does exercise its option under transaction A on 1 April 1996 then you should consider this paragraph to constitute notice by Scottish Provident Institution of exercise of its option under transaction B also on 1 April 1996.

Please confirm that the above proposals are acceptable and let me know any other matters which you think may usefully be considered before 1 April."

13. Ms Harrold replied by fax on 28 March. She confirmed that if on 1 April both options were exercised, stock deliveries and sums due (including the £20m collateral deposit) would be netted off

" … with the result that neither stock nor money would be exchanged between us. Moreover, as there will be no requirement for settlement through the CGO there is no need for either Citibank or Scottish Provident to issue instructions regarding settlement to the CGO nor notify the CGO in any other respect of the exercise of the above transactions."

She also stated that if SPI exercised its option on 1 April "then you should consider this paragraph to constitute notice by Citibank of exercise of its option under transaction A also on 1 April 1996."

14. On 1 April 1996 Mr Paterson faxed to Ms Harrold:

"We hereby exercise our option.

I note that per your letter of 28 March 1996 your option under transaction ref 1224895 is also exercised.

Settlement is agreed to be by offset per your letter of 28 March 1996 and my letter to you of 20 March 1996."

Ms Harrold replied by fax:

"I confirm receipt of your fax this morning notifying exercise of your option and accepting consequent exercise of our option under our letter of 28 March 1996. I confirm that settlement is to be by offset as per our letter of 28 March 1996 and your letter of 20 March 1996."

15. Despite Mr Burke's note as to the need for caution SPI made an accounting error in reporting its results for 1995. The special commissioners (para 8) described it as follows:

"Because of an error caused by the absence of values for the options in the investment summary, the asset of the collateral deposit but not the net liability of the options was included in the accounts, resulting in an overstatement of assets by £20m. This was discovered when the Department of Trade and Industry return was made. The auditors agreed that the error was not material."

The special commissioners

16. The special commissioners (Mr J Gordon Reid QC and Dr John F Avery Jones CBE) gave a detailed written decision (reported at [2002] STC (SCD) 252) which began by summarising the course of the hearing, and the scheme in outline. Then para 5 (headed "Principal findings-in-fact") contained 19 sub paragraphs, some of which have already been quoted. Parts of para 5 contained, not only findings of primary fact, but also evaluative findings; and there were more evaluative findings in later paragraphs. The most important of these are as follows:

(i) Para 5 (18):

"Transactions A and B were entered into by [the] taxpayer company and Citibank acting at arm's length. The options and premiums payable were negotiated at market rates. When transactions A and B were entered into along with the collateral agreement, there was a genuine commercial possibility of movement of interest rates and gilt prices such that it would be in Citibank's commercial interests to either refrain from exercising option A or exercising or attempting to exercise it on a date different from the exercise by the taxpayer company of option B. There was a genuine commercial possibility and a real practical likelihood that the two options would be dealt with separately. Likewise, there was a genuine commercial possibility and a real practical likelihood that option B would not be exercised by the taxpayer company."

It will be apparent that these observations assume that Citibank and SPI were at liberty to act as either thought fit in relation to its option, regardless of the terms of the scheme which Citibank had sold to SPI. The special commissioners returned to this point in paragraph 26 (below).

(ii) (Paras 22, 24, 25):

"The options are therefore self-cancelling if there is no practical likelihood or no genuine commercial possibility of the price falling below 90 . . . Our decision, based on this evidence, is that the price falling below 90 was unlikely but not so unlikely that one could say that there was no practical likelihood of its occurring, and accordingly that there was a genuine practical likelihood or to put it another way a genuine commercial possibility that the taxpayer company would not exercise option B . . . It follows that there was a genuine practical likelihood or a genuine commercial possibility that the taxpayer company would

> not exercise option B. The result would be that the taxpayer company would make a profit and Citibank a loss.
>
> We consider that, while it is near the limit, this degree of uncertainty saves the transactions from being ignored for tax purposes . . . They were genuine transactions under which the parties could make a profit or loss even though the expectation was that they would not."
>
> (iii) (Para 26):
>
> "There was no agreement that the options would not be exercised early. Each party was free to exercise the options if it wanted."
>
> (iv) (Para 28):
>
> "We find that the collateral agreement is separate from the two options. It consisted of a genuine loan or at least a genuine deposit. Its purpose was to provide Citibank with security and to remove the incentive for Citibank to exercise option A early. There was no right to offset it against payments under the options."
>
> (v) (Para 39):
>
> "The collateral agreement is clearly linked to the options but it is a separate agreement making a loan or deposit that is not part of the options."
>
> (vi) (Para 40):
>
> "Mr Moynihan argues that because of the agreement to net off made on 28 March 1996 there were no subsisting rights and duties under the options. We do not agree. The agreement to net off said merely that if both parties exercised their options, then neither stock nor money would be exchanged, and if the taxpayer company did exercise its option then Citibank should be taken to have exercised its option. Both options continued in place and although, by 28 March 1996, both parties expected to exercise their options, their rights and duties under the two options continued to subsist."

The special commissioners thus made a finding of fact, which a court hearing an appeal on a question of law is not entitled to disturb, that there was an outside but commercially real possibility that circumstances might occur in which the two options would not be exercised so as to cancel each other out. The question of law is whether, in a case in which they were in fact exercised so as to cancel each other out, the existence of this contingency prevented the commissioners from applying the statute to the scheme as it was intended to operate and as it actually did operate. The commissioners thought that it obliged them to treat the options as separate transactions.

The Inner House

17. The Inner House of the Court of Session (the Lord President (Cullen), Lady Cosgrove and Lord Eassie) dismissed the Inland Revenue's appeal in a reserved opinion of the court delivered by the Lord President ([2003] STC 1035, 1056). The court rejected the Inland Revenue's criticisms of the special commissioners' findings and reasoning.

The question of construction

18. SPI is entitled to treat the loss suffered on the exercise of the Citibank option as an income loss if the option was a "qualifying contract" within the meaning of section 147(1) of the Finance Act 1994. Section 147A(1) (inserted by the Finance Act 1996) provides that a "debt contract" is a qualifying contract if the company becomes subject to duties under the contract at any time on or after 1 April 1996. By section 150A(1) (also inserted by the Finance Act 1996) a "debt contract" is a contract under which a qualifying company (which means, with irrelevant exceptions, any

company: see section 154(1)) “has any entitlement…to become a party to a loan relationship”. A “loan relationship” includes a government security. So the short question is whether the Citibank option gave it an entitlement to gilts.

19. That depends upon what the statute means by “entitlement”. If one confines one’s attention to the Citibank option, it certainly gave Citibank an entitlement, by exercise of the option, to the delivery of gilts. On the other hand, if the option formed part of a larger scheme by which Citibank’s right to the gilts was bound to be cancelled by SPI’s right to the same gilts, then it could be said that in a practical sense Citibank had no entitlement to gilts. Since the decision of this House in *W T Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300 it has been accepted that the language of a taxing statute will often have to be given a wide practical meaning of this sort which allows (and indeed requires) the court to have regard to the whole of a series of transactions which were intended to have a commercial unity. Indeed, it is conceded by SPI that the court is not confined to looking at the Citibank option in isolation. If the scheme amounted in practice to a single transaction, the court should look at the scheme as a whole. Mr Aaronson QC, who appeared for SPI, accepted before the special commissioners that if there was “no genuine commercial possibility” of the two options not being exercised together, then the scheme must fail.

Applying the construction

20. Mr Aaronson submitted, as had been argued successfully before the special commissioners and the Inner House, that even if the parties intended that both options should be exercised together, as contemplated in Ms Harrold’s memorandum of 27 June 1995, the court could treat them as a single transaction only if there was “no practical likelihood” that this would not happen. On this point, SPI has the benefit of the findings of fact by the special commissioners to which we have referred in paragraph 16 above. The commissioners adopted (at para 24) the analogy of horserace betting:

> “If the chance of the price movement occurring was similar to an outsider winning a horse race we consider that this, while it is small, is not so small that there is no reasonable or practical likelihood of its occurring; outsiders do sometimes win horse races.”

21. Mr Aaronson said that a test of “no practical likelihood” derived from the speech of Lord Oliver of Aylmerton in *Craven v White* [1989] AC 398, 514 and assented to by Lords Keith of Kinkel and Jauncy of Tullichettle. In that case, however, important parts of what was claimed by the Revenue to be a single composite scheme did not exist at the relevant date. As Lord Oliver said (at p 498):

> “[T]he transactions which, in each appeal, the Inland Revenue seeks now to reconstruct into a single direct disposal from the taxpayer to an ultimate purchaser were not contemporaneous. Nor were they pre-ordained or composite in the sense that it could be predicated with any certainty at the date of the intermediate transfer what the ultimate destination of the property would be, what would be the terms of any ultimate transfer or even whether an ultimate transfer would take place at all.”

22. Thus there was an uncertainty about whether the alleged composite transaction would proceed to completion which arose, not from the terms of the alleged composite transaction itself, but from the fact that, at the relevant date, no composite transaction had yet been put together. Here, the uncertainty arises from the fact that the parties have carefully chosen to fix the strike price for the SPI option at a level which gives rise to an outside chance that the option will not be exercised. There was no commercial reason for choosing a strike price of 90. From the point of view of the money passing (or rather, not passing), the scheme could just as well have fixed it at 80 and achieved the same tax saving by reducing the Citibank strike price to 60. It would all have come out in the wash. Thus the contingency upon which SPI rely for saying that there was no composite transaction was a part of that composite transaction; chosen not for any commercial reason but solely to enable SPI to claim that there was no composite transaction. It is true that it

created a real commercial risk, but the odds were favourable enough to make it a risk which the parties were willing to accept in the interests of the scheme.

23. We think that it would destroy the value of the *Ramsay* principle of construing provisions such as section 150A(1) of the 1994 Act as referring to the effect of composite transactions if their composite effect had to be disregarded simply because the parties had deliberately included a commercially irrelevant contingency, creating an acceptable risk that the scheme might not work as planned. We would be back in the world of artificial tax schemes, now equipped with anti-*Ramsay* devices. The composite effect of such a scheme should be considered as it was intended to operate and without regard to the possibility that, contrary to the intention and expectations of the parties, it might not work as planned.

24. It follows that in our opinion the special commissioners erred in law in concluding that their finding that there was a realistic possibility of the options not being exercised simultaneously meant, without more, that the scheme could not be regarded as a single composite transaction. We think that it was and that, so viewed, it created no entitlement to gilts and that there was therefore no qualifying contract.

25. Mr Aaronson submitted that SPI have merely taken legitimate advantage of a gap in the transitional provisions of the 1996 Act. Paragraph 25 of Schedule 15 has the effect of preventing a company from claiming that a loss made after 1 April 1996 as a result of the exercise of an option granted before that date is an income loss. But it applies only to companies which would have been liable to tax before 1 April 1996 if the transaction had produced a gain: see para 25(1)(b). SPI was not so liable and Mr Aaronson submits that it was entitled to order its affairs to take advantage of its position.

26. It may be that if the Citibank option had stood alone, it would have been a qualifying contract and SPI would have sailed through the gap. Mr Moynihan QC, for the Inland Revenue, advanced a number of arguments of a more or less technical nature which he said would have prevented this from happening. But we need not discuss these points because SPI chose to enter into arrangements which, viewed as a whole, did not create a qualifying contract at all. On this ground we would allow the appeal.