Appeal number: FTC/19/2009

CAPITAL GAINS TAX – securities issued in exchange for shares – whether securities became qualifying corporate bonds on subsequent amendment of terms – yes – whether amendment amounted to a conversion of securities – yes – whether gain on subsequent redemption chargeable to tax – yes – appeal dismissed

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

MICHAEL RONALD KLINCKE **Appellant**

- and -

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

TRIBUNAL: MR JUSTICE NEWEY
JUDGE MALCOLM GAMMIE CBE QC

Sitting in public at The Royal Courts of Justice, London WC2 on 28 April 2010

Mr Julian Ghosh QC and Miss Elizabeth Wilson, instructed by KPMG LLP, for the Appellant

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

DECISION

1. This is an appeal from a decision of the First-tier Tribunal (Judges Sir Stephen Oliver QC and Aleksander) released on 1 July 2009 dismissing an appeal by Mr Michael Klincke against an assessment to capital gains tax ("CGT") in respect of a gain arising on the redemption of certain loan notes ("the Notes").

The two issues in this appeal

2. The appeal raises two particular issues:

(1) The first is whether the gain that accrued to Mr Klincke on the redemption of the Notes was a chargeable gain. This depends upon the application of section 115(1) of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992"), which provides that a gain that accrues on the disposal of qualifying corporate bonds ("QCBs"), as defined in section 117, "shall not be a chargeable gain". The question is whether the Notes were QCBs at redemption. It is common ground that the Notes were not QCBs on issue. They must therefore have become QCBs when their terms were amended shortly before redemption. If the amendments did not have that effect (so that the Notes remained non-QCBs) then the gain that accrued to Mr Klincke on redemption was chargeable to tax.

(2) The second issue arises if the Notes were QCBs at redemption. If the amendments that transformed the Notes into QCBs amounted to a "conversion" of the Notes within the meaning of section 132 TCGA 1992 any unrealised gain on the Notes immediately prior to conversion would have to be identified and would be chargeable on their later redemption, notwithstanding that on redemption the Notes were QCBs. In this respect the Notes were acquired as part consideration for the sale of shares in a trading company controlled by Mr Klincke and others. The unrealised gain on conversion would therefore include the gain arising on the sale of the shares and "rolled over" into the Notes.

3. The First-tier Tribunal dismissed Mr Klincke's appeal on the grounds that the amendment to the terms that transformed the Notes into QCBs was a "conversion" within section 132, with the consequence summarised in paragraph 2(ii) above. The Tribunal expressed no final view on the first issue because the Judges were unable to agree on the effect of the amendments. Judge Sir Stephen Oliver QC was inclined to think that the Notes were QCBs on redemption while Judge Aleksander thought that they were not. We agree with Sir Stephen Oliver on the first issue but have concluded against the Appellant on the second issue. We therefore dismiss Mr Klincke's appeal.

4. The relevant facts and the application of much of the relevant CGT legislation are not in dispute. They can be summarised briefly to provide the context for our discussion of the issues and our conclusion.

Background and issues

The 1993 exchange

5. On 2 July 1993 Mr Klincke and his fellow shareholders contracted to sell the entire issued share capital of High Speed Productions (Holdings) Ltd ("HSP") to Rubicon Group plc ("Rubicon"). Mr Klincke received in exchange for his HSP shares 1,109,134 10p shares in Rubicon (a small part of which were held for another shareholder) and the Notes which had a nominal value of £1,857,992. It is common ground that at the time of issue (and at all times thereafter until the events of 17 October 1995) the Notes were not QCBs.

6. A straightforward sale by Mr Klincke of his HSP shares would have been a disposal for CGT purposes and would have led to the computation and charging to tax of the gain arising on that occasion (section 1(1) TCGA 1992). The issue of the Rubicon shares and the Notes in exchange for his HSP shares, however, qualified as an "exchange" within section 135 TCGA 1992. This meant that sections 127 to 131 TCGA 1992 applied to the exchange as if HSP and Rubicon were the same company and the exchange were a reorganisation of that company's share capital (section 135(3)).

7. Section 127 sets out the principal consequences that flow as a result ("reorganisation treatment"). First, the reorganisation (or in this case the exchange) is not treated as involving any disposal of the HSP shares or any acquisition of the Rubicon shares or the Notes ("the no disposal fiction"). Second, the HSP shares (taken as a single asset) and the Rubicon shares and the Notes (taken as a single asset) are treated "as the same asset acquired as the [HSP shares] were acquired" ("the same asset fiction"). The effect of reorganisation treatment in 1993 was therefore that Mr Klincke did not have to compute the gain arising on his sale of his HSP shares (the no disposal fiction) but the cost of his HSP shares and (so far as relevant to any computation) the date of acquisition of his HSP shares would be taken as the cost and date of acquisition of the Rubicon shares and the Notes for the purpose of computing the gain (or loss) arising on a later disposal of those shares or the Notes.

8. We should note at this point that the usual reorganisation treatment may be modified in the case of a reorganisation that involves a QCB. Section 115 TCGA 1992 provides that a gain that accrues on the disposal of a QCB is not a chargeable gain. Section 116 then provides a special regime in any case where reorganisation treatment would otherwise apply but where the reorganisation involves a QCB. Section 116 comes into play at a later stage in this case (see paragraphs 14-16 below) but the section was irrelevant to the exchange in 1993 because the exchange did not involve a QCB. What Mr Klincke sold was his HSP shares and what he received was the combination of Rubicon shares and the Notes, which at that time were not QCBs.

The amendment of the terms of the Notes

9. The next relevant event occurred on 17 October 1995 when an extraordinary meeting of the Noteholders took place. The reason why the Notes were not QCBs was

because the terms of the Notes made provision for Rubicon (at its election) to redeem the Notes in a currency other than sterling. The purpose of the extraordinary meeting of Noteholders was (with Rubicon's consent) to propose and pass an extraordinary resolution modifying the terms of the loan note instrument to cancel Rubicon's foreign currency right.

10. The extraordinary resolution that was proposed and passed at the meeting was in the following terms—

> "THAT the terms of an instrument dated 20th August 1993 made between the Company and Lloyds Bank plc constituting £3,503,004 Loan Notes and the rights attached to the Loan Notes constituted by the said instrument be and are hereby modified and abrogated by the deletion of Clauses 4.2 and 4.3 of the said instrument and that a proposed Deed of Amendment to be made between the Company and Lloyds Bank plc effecting such amendment, a draft of which was produced to the meeting and initialled by the Chairman for the purposes of identification, be and is hereby approved."

11. Later on 17 October 1995, following the meeting, the deed of variation was executed by Rubicon and Lloyds Bank plc (as guarantor of the Notes) giving effect to the extraordinary resolution. The deed recited in full the terms of clauses 4.2 and 4.3 of the loan note instrument and recited the extraordinary resolution of Noteholders approving the deletion of these clauses. The operative provisions of the deed were as follows—

> "NOW IT IS HEREBY AGREED AND DECLARED by and between the parties as follows:
>
> 1. To modify and abrogate the wording of the Loan Note Instrument and the rights attached to the Loan Notes constituted thereby by deleting clauses 4.2 and 4.3 of the Loan Note Instrument in their entirety.
>
> 2. That subject to the modification and abrogation set out in clause 1 above all the terms and conditions of the Loan Note Instrument and the rights attached to the Loan Notes constituted thereby shall remain in full force and effect and shall be binding on all the parties.
>
> 3. That this Deed is Supplemental to the Loan Note Instrument."

12. The First-tier Tribunal records that the meeting and the amendments were part of a "scheme" to convert the Notes into QCBs, because QCBs would not give rise to any chargeable gain, and that the amendments had no other purpose. The First-tier Tribunal accordingly concluded on the evidence before it that the sole purpose of the amendments was to turn the Notes into QCBs with the intention of avoiding the CGT

that would otherwise arise on the disposal of the Notes. In this respect the reorganisation treatment that is accorded in the case of an exchange depends upon the taxpayer demonstrating that the exchange is undertaken for bona fide commercial reasons and is not part of a scheme or arrangements of which the main purpose, or one of the main purposes, is the avoidance of liability to capital gains tax (section 137 TCGA 1992). The amendments to the terms of the Notes were not envisaged in 1993 (so as to compromise reorganisation treatment at that time). Furthermore, there is no other statutory provision that makes the purpose of the amendments in any way relevant to the tax issues that arise in this case. We do not therefore consider this finding of the First-tier Tribunal to be of significance in arriving at our decision.

13. It is in relation to the amendment of the Note terms that the dispute arises. It appears to be common ground that the amendments were not of such a nature as to involve any disposal of the Notes (within the ordinary conception of a disposal for CGT purposes). But did the amendments amount to a conversion of securities within section 132 TCGA 1992? The significance of this question arises from the fact that section 132 applies reorganisation treatment to a conversion so that the no disposal fiction and the same asset fiction apply to whatever was held before and what emerges from the conversion. Two questions have to be answered in this connection—

(1) First, if the amendments to the Note terms involved no disposal in its ordinary CGT conception, is section 132 applicable given that one element of reorganisation treatment is the no disposal fiction? In other words, does section 132 presuppose a transaction that would otherwise involve a disposal and is the expression “conversion of securities” to be so understood?

(2) Second, if a “conversion of securities” can encompass a transaction that does not involve any disposal in its ordinary CGT conception, did the amendments to the Note terms amount to a conversion of the Notes within the meaning of section 132?

14. The relevance of these questions lies in the potential application of section 116 TCGA 1992 if there was a conversion. As we noted in paragraph 8 above, where a reorganisation (including a conversion of securities) involves a QCB section 116 may operate to modify the ordinary reorganisation treatment that would otherwise apply. Key to the application and operation of section 116 is the requirement either—

(1) that what is held before the reorganisation (in this case the conversion, if there was one) consists of or includes a QCB and what is held after the reorganisation does not, or

(2) that what is held before the reorganisation does not consist of or include a QCB and what is held after the reorganisation does.

Thus, in the present case section 116 would not apply if the Notes remained non-QCBs after the conversion. In that case, however, the Notes would continue to be within the charge to tax. On the other hand, if the Notes became QCBs on the conversion section 116 would apply a “modified” reorganisation treatment on that event.

15. The “modified” reorganisation treatment prescribed by section 116 for the conversion in that event is as follows—

(1) The ordinary reorganisation treatment is disapplied (section 116(5));

(2) The amended Notes (as QCBs) are treated as acquired at the time of conversion and for a consideration equal to the market value of the unamended Notes (as non-QCBs) immediately before the conversion (section 116(6)); and

(3) The conversion is not treated as involving any disposal of the unamended Notes (as non-QCBs) but (section 116(10))—

(a) the gain or loss that would have accrued on a disposal of the unamended Notes at their market value immediately before conversion must be calculated, and

(b) that gain or loss is “held over” until a subsequent disposal of the amended Notes (as QCBs), but

(c) on that subsequent disposal only the actual gain or loss that accrues on the amended Notes (as QCBs) is not a chargeable gain (or a non-allowable loss) under section 115; any gain or loss on the unamended Notes (as non-QCBs) held-over under (ii) above is taxed or allowed at that point.

16. Accordingly—

(1) If the amendments did not transform the Notes into QCBs, section 116 would not apply. Whether or not the amendments amounted to a conversion of securities, the Notes would remain as they always had been, chargeable assets acquired at the same time and for the same consideration as the HSP shares.

(2) If the amendments did transform the Notes into QCBs, and also amounted to a conversion of securities within the meaning of section 132, section 116 would ensure that no immediate gain arose but that any gain up to the point of conversion (calculated by reference to the acquisition cost and time of acquisition of the HSP shares and the market value of the Notes immediately before conversion) would arise on a subsequent disposal of the Notes.

(3) On the other hand, if the amendments transformed the Notes into QCBs but did not involve any conversion, section 115 would ensure that the whole of the gain on a subsequent disposal of the Notes (including any gain that could be traced to the HSP shares) would not be a chargeable gain.

<u>*Redemption*</u>

17. Following the extraordinary resolution Mr Klincke gave notice requiring Rubicon to repay £1,857,942 nominal value of his Notes, which it duly did on 27 October 1995. It is common ground that the redemption of the Notes amounted to a disposal, so that it then becomes necessary to determine which of the three scenarios set out in paragraph 16 is correct.

Discussion

Were the Notes QCBs at the time of redemption?

18. The definition of a QCB is contained in section 117 TCGA 1992. The relevant parts of section 117 read (as they applied at the time) as follows:

> "(1) For the purposes of this section, a 'corporate bond' is a security, as defined in section 132(3)(b)—
>
> (a) the debt on which represents and has at all times represented a normal commercial loan; and
>
> (b) which is expressed in sterling and in respect of which no provision is made for conversion into, or redemption in, a currency other than sterling;
>
> and in paragraph (a) above 'normal commercial loan' has the meaning which would be given by sub-paragraph (5) of paragraph 1 of Schedule 18 to the Taxes Act if for paragraph (a)(i) to (iii) of that sub-paragraph there were substituted the words 'corporate bonds (within the meaning of section 117 of the 1992 Act)'.
>
> (2) For the purposes of subsection (1)(b) above—
>
> (a) a security shall not be regarded as expressed in sterling if the amount of sterling falls to be determined by reference to the value at any time of any other currency or asset; and
>
> (b) a provision for redemption in a currency other than sterling but at the rate of exchange prevailing at redemption shall be disregarded."

19. There is no dispute that until the events of 17 October 1995 the Notes were not QCBs for the purposes of CGT. The effect of the deed of variation, coupled with the extraordinary resolution of that date, was to remove Rubicon's right to redeem in US dollars from the terms of the loan note instrument. There ceased to be any provision made for redemption in a currency other than sterling. Did the Notes, as a result, become QCBs on the basis that following the variation "no provision is made for … redemption in ... a currency other than sterling"?

20. A similar question arose in *Harding v Revenue and Customs Commissioners* [2008] EWCA Civ 1164, [2008] STC 3499. The taxpayer in *Harding* had received loan notes as consideration for a share sale. The loan notes were denominated in sterling but contained an option for the holder, exercisable within ten days of giving a redemption notice, to have the notes redeemed in US dollars, Canadian dollars or in Deutsche marks. The loan notes were therefore not QCBs. Notice of redemption was served on 13 January 1995 for redemption in July 1995. The taxpayer did not exercise

his option by 23 January and, as a result, the foreign exchange rights attached to the loan notes lapsed. Redemption duly occurred in sterling in July. The Court of Appeal decided that the taxpayer's loan notes remained "non-QCBs" until redemption. In arriving at this conclusion, Lawrence Collins LJ said as follows—

> "[55] In my judgment the key to the interpretation of s 117(1)(b) is the word 'provision'. If one were to ask whether, on the date of issue, provision is made 'in respect of' the security (meaning for this purpose the agreement represented by the loan notes and the terms embodied in them) there would, of course, be no doubt on any possible view.
>
> [56] But if the same question were to be asked at the date when the currency conversion right lapsed or when the loan notes were redeemed there would, in my view, be the same answer, namely that 'provision' is made for conversion, even though the right can no longer be exercised. In my judgment the word 'provision' is a reference to the terms of the agreement, and not simply to subsisting rights. There was no need for s 117(1)(b) to have the phrase 'at all times' because it was looking to the terms of the agreement and not to rights which may have existed under it from time to time."

21. Mr Ghosh QC on behalf of Mr Klincke stressed that following the amendment of the Note terms Rubicon no longer had an option to redeem the Notes in US dollars. That option was no longer any part of the terms of the parties' continuing agreement. It had been excised from the agreement. In this respect he said that it was fundamentally different to a term that had merely lapsed: in other words, a term that remained one of the terms of the parties' agreement but where the rights that it conferred were no longer subsisting or exercisable. He suggested that to take account of a term after it had been excised would be to read section 117(1)(b) as encompassing "[a security] … in respect of which no provision is [or ever has been] made for … redemption in … a currency other than sterling …".

22. Mr Gibbon for the Commissioners focused his submissions principally on the second issue, on the basis that there was no substantive difference on the figures whether the Notes were QCBs pregnant with a gain that had been crystallised and held over on 17 October 1995 or whether they were non-QCBs that gave rise to a chargeable gain on redemption on 27 October 1995. To the extent, however, that we decided to address the first issue, he submitted that there was no relevant difference between the situation in *Harding*, where the foreign currency option had "lapsed and ceased to have any effect" and the current situation in which the note terms had been "modified and abrogated" so as to remove the foreign currency option.

23. The First-tier Tribunal had divided views on this issue. As appears from their decision, Judge Aleksander preferred the analysis of HMRC on the basis that the effect of the deed of variation of 17 October 1995 had not been to cause the loan note instrument no longer to include any provision for redemption in a currency other than

sterling. This was because the deed of variation was a document expressed to be supplementary to the loan note instrument; it did not therefore supersede it. Following 17 October, the loan note instrument had to be interpreted in the light of the deed of variation, and vice versa—the two documents were legally stapled together and had to be read together. He considered that following 17 October the loan note instrument continued to include a provision for redemption in US dollars, even though that provision was no longer operative. In contrast, Judge Sir Stephen Oliver QC took the view that, once the deed of variation had been executed, there was no longer any provision for redemption in a foreign currency. The relevant clauses had, as he saw it, ceased to exist by common consent of all the parties to the loan note instrument, albeit that the effect of the deed of variation could not be understood without reference to the original loan note instrument.

24. The point that Mr Ghosh QC makes (see paragraph 21 above) about having to read words into section 117(1)(b) gains some support from section 117(1)(a). This requires that the debt represented by the QCB "has at all times" represented a normal commercial loan. It is common ground that the Notes satisfy this condition but the language of paragraph (a) and (b) of section 117(1) in this respect indicates that while the debt in question must always have satisfied the relevant condition, the security representing that debt is to be determined for what it is at the relevant time. One way to consider this is to ask whether a purchaser of the Notes following the amendment of the terms would have acquired a QCB or a non-QCB. What was amended was clause 4 of the instrument constituting the Notes. The form of the Note is set out in schedule 1 to the instrument. This refers to the instrument constituting the Notes and to the fact that the provisions of the instrument may be modified, abrogated or compromised in any way with the sanction of an extraordinary resolution of the Noteholders and with the consent of Rubicon. On any transfer, the holder must surrender his certificate before the transfer can be registered and any new certificate can be issued. Should a new Noteholder be regarded as holding a non-QCB because the terms of the instrument constituting the Notes originally conferred an option for the issuer to redeem the Notes in a foreign currency, even though that had never represented a term of the Notes in the new Noteholder's hands? Unless the Notes are issued to and held by Noteholders on different terms then whatever is the correct answer for a new Noteholder must be equally true for those who were originally issued with Notes and continue to hold them.

25. The difference between a note that has been issued on terms that provide for redemption in a foreign currency but where that term has lapsed and a note where the terms have been amended to excise the foreign currency redemption option is in our view critical. In the first case the foreign currency option remains one of the terms on which the note is held even though it is no longer operative or effective. In terms of construing the definition of a QCB in section 117 it seems unlikely that Parliament envisaged that the status of a note (and the character of the gain that the note might reflect) would automatically alter (without any change in the terms on which it was issued and held) according to whether a particular term was currently or prospectively operative or had lapsed. On the other hand, if the issuer and the noteholders take the positive step of changing the terms of the notes the character of the notes is to be determined according to the provisions as amended. The amendment may lead to the

loan note instrument being reissued in amended form, re-executed or left to be read with a deed of variation. In any of those cases, however, the note no longer contains any provision for conversion into, or redemption in, a currency other than sterling. This may be contrasted with the situation in *Harding*, where the loan notes did include a provision to that effect but in the circumstances the provision had lapsed.

26. Accordingly, we have concluded that the Notes became QCBs following their amendment on 17 October 1995.

27. We suggested to Mr Ghosh QC that if the "same asset" fiction were taken to its logical conclusion it might be said that the Notes should always be regarded in Mr Klincke's hands as the original shares that the Notes represented. The "new holding" of the Notes might therefore be regarded as always continuing to be a chargeable asset in his hands rather than becoming non-chargeable QCBs. Mr Ghosh QC considered that the same asset fiction only operated for the purpose of computing the gain and did not dictate the chargeable or non-chargeable character of the Notes on their redemption. For his part Mr Gibbon seemed disinclined to argue for a more extensive application of the "same asset" fiction and we have therefore given this no further consideration.

<u>Did the amendment of the Notes amount to a "conversion"?</u>

28. Section 132 TCGA 1992 is headed "Equation of converted securities and new holding". So far as is relevant it provides as follows:

> "(1) Sections 127 to 131 shall apply with any necessary adaptations in relation to the conversion of securities as they apply in relation to a reorganisation (that is to say, a reorganisation or reduction of a company's share capital). …
>
> (3) For the purposes of this section and section 133—
>
> (a) 'conversion of securities' includes—
>
> (i) a conversion of securities of a company into shares in the company, and
>
> (ii) a conversion at the option of the holder of the securities converted as an alternative to the redemption of those securities for cash, and
>
> (iii) any exchange of securities effected in pursuance of any enactment (including an enactment passed after this Act) which provides for the compulsory acquisition of any shares or securities and the issue of securities or other securities instead."

29. Mr Ghosh QC for Mr Klincke points out that the expression we have to construe is not "conversion" *simpliciter* but "conversion of securities". He accepts that the

word "conversion" is aptly to be understood in its ordinary sense as comprising any "change in character, nature, form or function" but points out that all the transactions specified in subsection (3)(a) are transactions in which one type of interest in a company is replaced by another in circumstances where there would ordinarily be said to be a disposal of one interest and the acquisition of another. This, he says, is consistent with the no disposal fiction, which is an essential element of reorganisation treatment. While he accepts that the transactions contemplated in subsection (3)(a) are not exhaustive of the expression "conversion of securities", he says that in the present case there is no disposal in its ordinary conception for CGT purposes and Mr Klincke continues to hold the same security as he always held. It is just that the issuer no longer has the option to redeem the securities in US dollars.

30. In this respect Mr Ghosh QC drew a possible distinction between an issuer option and a holder's option. He pointed out that if Noteholders had been given the option to require redemption in foreign currency and had agreed to surrender their option, the variation of the Note terms in that respect might be said to have involved a part disposal of the Notes. In the present case, however, the removal of the issuer's option to redeem in foreign currency could not be said to involve any disposal of the Notes.

31. Mr Ghosh QC also made the point that it was no part of section 132's function to operate as a "charging" provision, to ensure that if the tax status of a security changed (from QCB to non-QCB or vice versa) any unrealised gain or loss was recognised for the purposes of the tax at that point in time. Reorganisation treatment was designed to ensure that gains or losses were not recognised in situations in which there had been no actual realisation of a person's investment in a company but where otherwise a person might be required to compute and pay tax, even though he had no "cash-in-hand" to do so. The no disposal fiction and the same asset fiction secured that outcome and the expression "conversion of securities" should be construed in the light of the overall purpose of the provisions.

32. We can accept much of Mr Ghosh's analysis of the purpose of these provisions. It is no part of the purpose of section 132 to secure (through its interaction with section 116) that gains or losses are recognised for CGT purposes where there is a change in the status of the security. The amendment to the Notes must therefore amount to a "conversion of securities" within the ordinary meaning of that expression without regard to the fact that in our view the amendment operated to transform the Notes from non-QCBs that could give rise to a chargeable gain or allowable loss to QCBs where any gain would not be chargeable and any loss would not be allowable. As this illustrates, the amendment could work in both directions. Before the amendment Mr Klincke would have been able to claim a loss if Rubicon had defaulted on the Notes; after amendment he could not. In practical terms Mr Klincke was never at that risk, given that the amendment was followed almost immediately by redemption, but that cannot affect the general point. The effect of the amendment cannot alter depending upon whether redemption follows immediately or at some later date.

33. Nevertheless, we do not believe that it is necessary that a transaction must amount to a disposal in its ordinary CGT conception for it to amount to a "conversion

of securities" within section 132. It is clear that the CGT charge depends upon there being a disposal (see section 1(1) TCGA 1992). When there is a disposal it then becomes necessary to look back to the history of ownership of the asset to compute the gain or loss that arises on that disposal. While the no disposal fiction is an essential element of reorganisation treatment, in cases in which there would otherwise be a disposal, that is not to say that the reorganisation (or in this case, conversion) must have involved a disposal that the no disposal fiction negates. In this respect the basic definition of a "reorganisation" that is found in section 126 TCGA 1992 can ordinarily encompass transactions that would not otherwise be thought to involve any disposal but where the single asset fiction facilitates the computation of the gain or loss on a later disposal.

34. The definition of "reorganisation" in section 126 cannot resolve whether or not a transaction amounts to a "conversion of securities" within the meaning of section 132 because that is a matter to be determined in its own right. In so far as one has to consider, however, whether section 132 only contemplates transactions that amount to a disposal in its ordinary conception on the basis that reorganisation treatment envisages both the no disposal fiction and the same asset fiction, section 126 is helpful in suggesting that Parliament did not envisage reorganisation treatment only extending to transactions that engaged both fictions.

35. Turning to section 116 it seems to us that the purpose and function of the section are clear. It is designed to ensure that non-chargeable gains (and non-allowable losses) attributable to QCBs cannot become chargeable gains (or allowable losses) where reorganisation treatment would otherwise have had that effect on a reorganisation, exchange or conversion. Similarly, it ensures that chargeable gains (and allowable losses) attributable to non-QCBs cannot become non-chargeable gains (or non-allowable losses) in such circumstances. Section 116, however, depends upon there being a transaction to which the ordinary reorganisation treatment applies, to which section 116 can then apply "modified" reorganisation treatment. Parliament may not have envisaged that it would be possible to transform a QCB into a non-QCB, or vice versa, without "tripping" the provisions of section 132. Nevertheless, the fact that a taxpayer has succeeded in changing the tax status of securities from QCB to non-QCB or vice versa cannot mean that section 132 must apply, opening the way for section 116 to apply its modified reorganisation treatment.

36. We are therefore driven back to the basic question whether the amendment of the Notes, to remove the issuer's option to redeem in US dollars, is within the ordinary meaning of the expression a "conversion of securities". Mr Gibbon for HMRC made some suggestion that this was essentially a question of fact for the First-tier Tribunal. That Tribunal accepted HMRC's arguments that the passing of the extraordinary resolution on 17 October 1995 approving the deed of variation and the execution of that deed amounted to a conversion within section 132. It arrived at that conclusion on the basis that the purpose and the effect of the extraordinary resolution and the deed was to change the nature of the Notes. Rubicon as issuer gave up its rights to repay in dollars (by reference to the foreign exchange rate on that date) and was left with the obligation under clause 6.1 to repay in sterling. Mr Klincke, as Noteholder, was left with the right to be repaid the nominal amount in sterling; until then he had been

entitled to be repaid something, but he could not say whether it would be sterling or US dollars until 15 days passed from the date on which he had sent notice of redemption. The rights and obligations of issuer and Noteholder were changed by the deed and the extraordinary resolution of 17 October. That was a conversion in the ordinary sense of the word. There is no necessary implication in the language of section 132 or in the wording of the reorganisation code in Chapter II of Part IV (as it existed at the time) which required a different meaning to be given to the word "conversion".

37. We do not think that the answer in this case can be characterised just as the determination of fact on which we are bound by the First-tier Tribunal's conclusion subject to the usual qualifications found in *Edwards v Bairstow* [1956] AC 14. It is a matter of arriving at the proper construction of the expression "conversion of securities" in section 132. In this respect, it seems to us that the principal function of the reorganization provisions, including section 132, is to ensure that provided he does not realize any immediate value from his investment in the company (usually through the receipt of cash or other consideration not in the form of shares or securities), a taxpayer can be unconcerned with whatever has changed in his investment in the company and that when he eventually realizes value by disposal he can compute his gain (or loss) on the basis that what is disposed of is what he originally acquired. This objective does not suggest that we should give a limited meaning to the expression "conversion of securities". The specific elaboration of the expression in section 132(3) encompasses transactions that might be thought to go beyond a "change in character, nature, form or function" of particular securities, by replacing the particular securities with something entirely different. In contrast, an amendment to the terms of particular securities – to the extent that it might otherwise raise questions of immediate disposal or of whether on a later disposal the securities are regarded as the same securities as those originally acquired – falls more naturally within the ordinary meaning of "conversion" in the sense of a "change in character, nature, form or function" of the securities in question, and therefore can automatically benefit from reorganization treatment.

38. Having concluded that a conversion of securities does not require a disposal in its ordinary conception and it being accepted that the ordinary meaning of the word "conversion" is, among other things, a "change in character, nature, form or function", we see no reason to differ from the First-tier Tribunal's conclusion that the change that came about as the result of the execution of the deed and the extraordinary resolution of 17 October 1995 falls squarely within the words "change in [the] character, nature [or] form" of the Notes. The consequence that flows from that conclusion is that section 116 applied on the conversion to identify and "freeze" the chargeable gain on 17 October 1995 and then operated to bring that gain into charge when the Notes were redeemed on 27 October 1995. That was not the result of section 132 operating as a charging provision. Each of section 132 and section 116 had effect according to their specific purpose: the former to ensure that the change in character, nature, form or function of the Notes benefited from reorganization treatment; the latter to modify that treatment because the effect of the amendment was to convert the Notes from non-QCBs to QCBs.

39. We therefore dismiss the appeal.

Mr Justice Newey

Malcolm Gammie
Upper Tribunal Judge

RELEASE DATE: 7 July 2010

FTC/19/2009