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LOAN RELATIONSHIPS AND TCGA 1992: CONVERSIONS

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The enactment of the loan relationship regime in FA 1996, Part IV, Chapter II and the consequent amendment of TCGA 1992 section 117 has created a potential anomaly in the tax treatment of capital gains tax payers (i.e. non-corporate tax payers) and companies within the corporation tax charge. All loan relationships, other than those within FA 1996 sections 92 and 93, are QCBs in the hands of a corporate tax payer, by reason of TCGA 1992, section 117(A1), whereas the pre-FA 1996 rules govern the CGT payer. What happens if a [creditor] loan relationship is assigned by a capital gains tax payer, say an individual in whose hands a creditor relationship is not a QCB (say because the assignor has an option to redeem in a foreign currency, in circumstances where there will be no deep gain) to a corporation tax payer, in whose hands the creditor relationship is a QCB, by reason of TCGA 1992, section 117(A1)? What is the tax analysis of the redemption of the loan note in the hands of the assignee company? This article considers whether a "conversion" within TCGA 1992 section 132 takes place on such an assignment. Although it might be thought that the assignee company would be indifferent to whether or not the assignment was or was not a "conversion", since redemption would be expected to yield a corporate debt profit (being the difference between the price paid and the redemption amount) in any event, the question is certainly not always academic, as is seen below.

Is the assignment, then, a "conversion"? TCGA 1992 section 132(3)(a) provides that 'conversion of securities' includes any of the following, whether effected by a transaction or occurring in consequence of the operation of the terms of any security...that is to say [the events specified in (i) to (iii), including "a conversion of a qualifying corporate bond into a security which is a security of the same company but is not such a bond"; section 132(3)(a)(ib); section 132(3)(a)(ia) addresses the converse circumstance]." Section 132(3)(a), therefore, contemplates two sets of

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events, namely "transactions" and "the operation of the terms of any security". It goes on to specify that the events in section 132(3)(a)(i) are a list of events which, being either a transaction or the operation of the terms of the security, are, in turn, "conversions" and tells us that this list (of such transactions and operation of terms) is not exhaustive (by expressly providing that the "conversion of securities" merely "includes" the events listed in section 132(3)(a)). In other words, section 132(3)(a) requires there to be either a transaction or the operation of the terms of a security and only then asks whether either event falls within one of the items in section 132(3)(a)(i) to (iii), in which case the event will be a conversion. The term "includes", in section 132(3)(a), contemplates that a transaction or the operation of the terms of a security may be a "conversion" even if it is outside the specific items set out in section 132(3)(a)(i) to (iii) but does not take away the requirement that a "conversion" must be either a transaction or arise from the operation of the terms of a security.

It is (just) possible to read section 132 as providing that "conversion of securities" merely "includes" the events listed in section 132(3)(a), which are transactions or arise from the operation of the terms of a security, and the reference to "transactions" and "the operation of the terms of any security" is illustrative only, so that it is irrelevant whether a particular event falls into either category, or, indeed, neither; on this view, even if an event within section 132(3)(a)(i) to (iii) occurs which is neither a "transaction", nor "the operation of the terms of a security", section 132 may still apply. In other words, section 132 catches all of the events specified in section 132(3)(a)(i) to (iii), which are transactions or arise from the operation of the terms of the security but it can catch any other "conversion" within section 132(3)(a)(i) to (iii), which are neither transactions, nor arise from the operation of the terms of any security, as well (because nothing in section 132 tells us that it cannot). This latter view is linguistically tenable but makes the reference in section 132(3) to "transactions" and the "operation of the terms of any security" redundant. Why, if the draftsman of section 132 did not care whether a "conversion" occurred by reason of a "transaction" or "in consequence of the operation of the terms of any security", did he refer to these terms at all? If a "conversion" which occurs, say, as a consequence of a change of law, was intended to be caught, it would have been far more sensible to have omitted these references altogether. It follows that the better view is that a "conversion" within section 132 must be "effected by a transaction" or occur in consequence "of the operation of the terms of any security".

To return to the assignment of the loan note by a CGT payer to a company within the charge to UK corporation tax, although the change in status from non-QCB to QCB could be said to be effected "by" the assignment, i.e. a "transaction", since the change could not have occurred without the assignment, it is not considered that this

is the better technical view. For a change in status to be "effected by" a transaction, the change must be "accomplished through the agency, means, or instrumentality of" the transaction (*Concise Oxford English Dictionary*, 9th Edition). Thus, to be within section 132, the "transaction" itself must cause ("effect") the change in status from non-QCB to QCB (or vice versa), i.e. the transaction itself must vary ("convert") the loan note so that it changes status. In the example given here, however, the change in status to QCB comes about due to the assignee being within the loan relationship provisions and TCGA 1992 section 117(A1); if the assignee had been, say, an individual or a non-UK resident company, no change in status would have occurred by reason of the assignment from a company not itself within the corporation tax charge. Section 132 does not apply if a change in status occurs "in connection with" a transaction; the change must be effected "by" the transaction. Put another way, the change must occur only by reason of the transaction, not by any other consideration, such as the status of the holder It follows that the assignment described above does not invoke section 132.

However, the contrary view certainly cannot be dismissed as negligible, or merely theoretical. Indeed, it could be asked what possible reason the draftsman could have to exclude such an event from the application of section 132. It is nevertheless considered that such an approach extends the language of section 132(3) to beyond its normal meaning; "effected by" is not the same as "effected in connection with".

However, what is considered to be the better view produces its own (unpalatable-at least to the courts) anomalies. Assume that a non-UK resident company exchanged, several years ago, well before the advent of the loan relationship provisions was contemplated, shares for loan notes issued by the purchaser company, which loan notes were non-QCBs and that TCGA 1992 section 135 applied to the exchange. The shares had a latent gain of, say, £1m, which was "rolled into" the loan notes. The vendor company then "immigrates", i.e. becomes UK resident (at which point the loan notes become QCBs under section 117(A1)) and thereafter redeems the loan notes. What is the analysis here? The vendor company has clearly given full value for the loan notes, in the form of the shares sold to the purchaser. There is, therefore, no loan relationship taxable credit in its hands. The only tax which the Inland Revenue could hope to collect is the chargeable gain which was "rolled into" the loan notes. If section 132 does not apply to the change in status on the immigration of the company, this chargeable gain will simply not arise. The immigration is not a "transaction". The causal relationship between the only relevant "transaction" (i.e. the share for loan note exchange) and the change in status to QCBs is far more tenuous than in the previous example and it is difficult to see how the change in status could be said to have been "effected by" the share for loan note exchange, whatever view is taken of the meaning of that phrase Indeed, at the time of the share for loan note exchange, there was clearly no "conversion", on any

view. I have set out above why the proposition that section 132(3) should be construed as applying to all changes of status of securities, not just those effected by transactions or by reason of the operation of the terms of a loan relationship, appears to be a difficult argument on which to succeed.

If the change in status of the loan notes cannot be said to have been effected "by" a transaction, can the phrase "in consequence of the operation of the terms of any security" be construed sufficiently widely to catch the change of status of the loan notes on immigration? As a matter of language, this latter phrase is, it is considered, confined to cases where a change in status occurs by reason of the application of the terms of the loan note themselves, rather than the status of the holder, or a change in the legal regime which governs the loan note. In other words, an event (such as a unilateral or bilateral variation of the terms of the loan note, or the application of one of the terms of the loan note, which may be dependent on the passing of time, or on the occurrence of a particular event) which varies the loan note, so that it changes status, from QCB to non-QCB, (or vice versa) is caught by section 132 but not any event which is not a variation ("conversion") of the terms of the loan note itself (such as a change in law, a change occurring because of the status of the holder, or the immigration in the above example). A contrary argument here would be that, on immigration, the terms of the loan note were such that the creditor relationship became a QCB in the hands of the vendor company. If, for example, the loan note had been a convertible security within section 92 of FA 1996, it would not have become a QCB on immigration. Hence the terms of the loan note have "operated" to cause the change in status. This view gives a most artificial meaning to the verb "operate". The terms of the loan note have not "operated " at all on immigration. It is the loan relationship provisions which have "operated", to make the loan note a QCB, not the terms of the loan note. It is true, of course, that if the terms of the loan note had been different (so that it was a section 92 or a section 93 asset) the loan note would not have become a QCB on immigration; this observation might tempt the courts towards the contrary view to ensure that tax did not escape the Revenue's net but this would be palm tree justice, making words say what they do not mean.

Also, the contrary view gives rise to difficult (I would say impossible) conceptual problems Suppose a company assigned a loan note to an individual (or vice versa). If the mere change in status of the holder of the loan note was sufficient to invoke section 132, when does this so-called "conversion" take place? In the hands of the company? No, because the loan note does not change status in the company's hands. Not in the hands of the individual either, because the loan note does not change status in the individual's hands. Who (the company or the individual) bears the burden of any latent gain? These questions themselves demonstrate the absurdity of trying to apply section 132 merely by reason of a change in status of the holder,

where a loan note is a QCB in the company's hands but a non-QCB in the individual's hands. This shows that the better view is indeed that a change in status of a loan note from QCB to non-QCB (or vice versa) which occurs merely by reason of a change in status of the holder or by any other operation of law cannot said to be"effected by" a transaction or occur by reason of the "operation" of the terms of the loan note. Thus, such events are outside the scope of section 132 altogether. I acknowledge that the better technical view means that tax is lost to the Inland Revenue in circumstances which could not possible have been intended by the draftsman in relation to the immigrating company described above but this is no less unenviable than the anomalies produced by the contrary view.