



**TC02591**

**Appeal number: TC 2012/03657**

*INCOME TAX – Discount – Flexi Notes – Floating Rate Notes stripped of interest for a certain period sold to Appellant as part of a Flexi-Note package – Increment realised on sale by Appellant at end of the period – Whether increment taxable as profits or gains under Case III of Schedule D*

**FIRST-TIER TRIBUNAL  
TAX CHAMBER**

**MALCOLM HEALEY**

**Appellant**

**- and -**

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

**TRIBUNAL:    SIR STEPHEN OLIVER QC  
                  DAVID E WILLIAMS CTA**

**Sitting in public in London on 12 and 14 February 2013**

**Kevin Prosser QC and Charles Bradley, counsel, for the Appellant**

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

## DECISION

1. This appeal by Mr Malcolm Healey (“Mr Healey”) relates to amendments made to his self-assessment return for 2003/4 on the closure of an inquiry into that return on 21 September 2011.
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2. The issue raised in this appeal is whether the “profit” made by Mr Healey on certain transactions relating to products, marketed under the name “Flexi-Notes”, is, as HMRC contend, chargeable to income tax. HMRC say that those profits are “discounts” of an income nature to be taxed under Case III (b) of Schedule D. Mr Healey contends that the profits were not discounts and, in any event, they were not of an income nature.
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3. In essence, Mr Healey was supplied by Kleinwort Benson Private Bank (“KB”) with six similar products described and marketed by KB as “Flexi-Notes”. Each Flexi-Note product contained a Floating Rate Note (“FRN”) issued by a corporate body (with an “A” or “Aa” credit rating) from which the interest coupons were to be stripped on the instructions of KB. The stripped coupons relating to a specified period (“the Flexi-Note Period”) were retained for the benefit of KB. The remaining interest coupons were, at the end of the Flexi-Note Period, reattached to the related FRNs (again on KB’s instructions) and those FRNs were then sold on the market by KB on behalf of Mr Healey.
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### *The Evidence*

4. We heard evidence from Mr AM Jones, a private banker. Mr Jones had been a member of the “structured products” team at KB throughout the period in which the transactions to which this appeal relates were carried out. Supporting documentation covering the marketing of the Flexi-Note products and their management and implementation was submitted in evidence and, where appropriate, covered by the oral evidence of Mr Jones.
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### *The price charged to the customer for the Flexi-Note product*

5. The price charged by KB to the customer for each Flexi-Note product was determined, as a first step, by taking the price that the related FRN was trading at in the market at the time of the supply of the product to that customer. As the interest coupon of the FRN represented a commercial rate of interest, i.e. LIBOR plus a percentage, that initial amount might be par or slightly more or less. From that initial amount a subtraction was made of the net present value of the stripped interest coupons relating to interest for the duration of the Flexi-Note Period (calculated by reference to swap rates). An addition to the price charged to the customer was KB’s fee. (The FRNs had been held, and the interest coupons stripped and reattached, electronically, through the EUROCLEAR system.)
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## ***EUROCLEAR***

6. The EUROCLEAR system is operated by Euroclear Bank SA of Belgium. EUROCLEAR functions as a clearing house for trading in bonds. It typically holds debt instruments issued in global form by issuing institutions. EUROCLEAR holds such instruments as registered “legal owner” on behalf of its participants. KB, as a participant, is recorded in EUROCLEAR’s books (in relation to the particular instrument). Transactions between KB and its customers in relation to any such instrument do not appear in EUROCLEAR’s records.
7. Coupons could be detached (stripped) and reattached to debt instruments registered with EUROCLEAR, on instructions from the owner, within the EUROCLEAR system. All six Flexi-Note products to which this appeal relates contained floating rate, as distinct from fixed income, notes. The EUROCLEAR operating procedures in force at the relevant time provided for instructions to detach in terms that were confined to fixed interest bonds. Instructions to strip coupons were acceptable from participants recorded as owners. The parties to this appeal acknowledged, on the strength of Mr Jones’s evidence, that a special arrangement had been reached with EUROCLEAR, at the design stage of the Flexi-Note product, that EUROCLEAR would accept instructions to strip coupons from floating rate FRNs. That arrangement was subject to at least one restriction, namely that the stripped coupons could not be traded within the EUROCLEAR system; they therefore had to remain registered with KB.

### ***The Specimen Flexi-Note product***

8. Between December 2001 and March 2002, Mr Healey was supplied by KB with six Flexi-Note products. These related to FRNs having an aggregate maturity value of £84,400,000. The parties agreed that one Flexi-Note product should be taken as an example and that our conclusions relating to that particular product would cover all five other products. The Flexi-Note product taken as the example related to £30,000,000 nominal of ANZ FR MTN 13/9/04, redeemable on that date at par. We refer to this as “the ANZ FRN”. Details of the other five FRNs to which the other five Flexi-Note products related are summarised in the Schedule to this Decision.

### ***Marketing the Flexi-Note product and its intended operation***

9. The transactions relating to the Flexi-Note products were entered into in pursuance of proposals contained in marketing documents provided by KB. On or around 17 January 2001, KB had written to Mr Healey concerning “*our cash investment product ‘the Flexi-Note’*”. KB supplied Mr Healey with a brochure providing “*an outline, current indicative terms and legal opinion on the product*” and stated that “*as a guide, the benefit to the investor (40% taxpayer) in cash terms is over £15.000 per annum per £1million invested*”.

10. The intended operation of the Flexi-Note product was that, once a customer had expressed an interest in buying the product, KB would purchase a FRN in the market. The FRN would have some accrued interest since the last coupon date. It was intended that the FRN would be a Qualifying Corporate Bond (“QCB”) within the meaning of section 17 of the Taxation of Chargeable Gains Act 1992; by virtue of being such any gain that accrued on the disposal of the FRN would not be a chargeable gain: see section 115 of that Act.
11. The intention was that, immediately following purchase, KB would strip the FRN of all future interest coupons (other than the immediately ensuing interest coupon). In each case the expectation was that, after payment of a pre-planned number of stripped interest coupons, the remaining interest coupons would be reattached. The number of interest coupons intended to be permanently stripped would depend on the customer’s wishes as to the length of time he wished to take advantage of the Flexi-Note product. (There was to be provision for consensual early termination of the product.) Stripping and reattachment instructions to EUROCLEAR were within the power of KB, but not with the customer.
12. Once the interest coupons had been stripped the Flexi-Note product was supplied to the customer, thereby giving the customer the equivalent to a beneficial interest in the underlying FRN. The price charged to the customer represented a “discount” to its redemption amount; this reflected the value of the interest coupons that had been stripped.
13. At the end of the intended Flexi-Note Period (and subject to early consensual termination), the expectations were that KB would give instructions for the remaining coupons to be reattached, and the customer would sell his interest in the FRN to or through the agency of KB. There was no set date on which the sale would take place. It was part of the intended operation of the Flexi-Note product that such a sale should happen.
14. The intention was that the customer would be chargeable to income tax on the initial unstripped interest coupon (though relief would be available in respect of the taxable income because of the amount of accrued income at the time of purchase, and the operation of the Accrued Income Scheme).

### ***The Marketing Brochure***

15. The Flexi-Note, as demonstrated by the Marketing Brochure provided by KB, was aimed at individuals and trustees with cash on which they wanted a return. The brochure starts with the words – “Objective of the Flexi-Note is to greatly enhance the after-tax return on surplus cash”, - “The minimum maturity is 12 months” and – “The minimum transaction size is £1 million”. The brochure states that the Flexi-Note “is suitable for UK taxpaying private individuals or their Trusts”. As regards risk, the brochure states that - “The investor’s risk is on the issuer of the security (predominantly leading UK banks...). The risks are similar to placing funds on deposit with the issuing institution”. The customer

holding the Flexi-Note is informed that, should he need to realise the Flexi-Note before maturity, he “*may sell the note back to KB or seek a bid in the open market*”.

- 5 16. The brochure provides the following detail about “*the Investment*”: – “*The client purchases a Flexi-Note. The underlying security of the Flexi-Note is a standard vanilla Floating Rate Note (“FRN”) that has had specific coupons removed. An FRN will trade in the market at or around par (100% of the face value). The Flexi-Note however is sold to the client at a price that reflects the removal of the coupons from the security. But if a requirement arises whereby some or all of the funds invested are required in the interim, the investment may be liquidated*”. The brochure drew a comparison between Flexi-Notes and cash deposits. It states that – “*The goal of the Flexi-Note is to provide the investor with an enhanced after-tax return that is significantly in excess of fixed-term deposits*”. The brochure in current use at the time of Mr Healey’s expression of interest states that – “*The after-tax return over the first twelve months is calculated to be 3.34%, which is equivalent to 5.57% before tax to a 40% tax payer assuming a buying price on the security of 100.125%. This compares favourably with the current one year sterling deposit rate of 3.75%*”.
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17. As we read the literature, the potential customers are assured that the nature of FRNs is that those notes can reasonably be expected to trade at or around par with all coupons attached and that, should they need to get out of the Flexi-Note during its Flexi-Note period, there is a reasonable assurance from KB that KB will facilitate this. Moreover, it is implicit in the calculations of return that, at the end of “term” (a word used by KB to refer to the end of the Flexi-Note period), KB will instruct, or arrange with, EUROCLEAR for the reattachment of the interest coupons to the underlying FRNs.
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30 ***Mr Healey’s Flexi-Note***

18. For present purposes, we are concerned with the Flexi-Note which had the ANZ FRN as its “underlying security”. In the course of November 2001 Mr Healey and his advisers had been informed by KB of FRNs that were available. Details were provided about the nominal amount available, the proposed term of the Flexi-Note and expected returns (based on the assumption of realisation at or around the term date). At the start of December 2001, Mr Healey signed an offer document from KB confirming his decision to proceed.
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- 40 19. On 6 December 2001, for settlement on 11 December 2001, KB (as principal) bought the ANZ FRNs in the market for a net consideration of £30,024,000. Also on 6 December 2001 (for settlement on 11 December) KB documents headed “Flexi-Note - Internal Deal “ and “Flexi-Note - Client Deal” show the sale by KB to Mr Healey of the ANZ FRNs for a net consideration of
- 45 £27,786,000. The latter document contains these words, under the heading “Special Instructions” - “*Excluding Coupons paid on 12/03/2002, 12/06/2002,*

12/09/2002, 12/12/2002, 12/03/2003, 12/06/2003 12/09/2003". (We refer to those coupons as "Coupons 2-8".)

5 20. The price charged to Mr Healey for the Flexi-Note (£27,786,000) was determined by (i) subtracting from the market value of the FRN on acquisition by KB the net present value of Coupons 2-8 and (ii) adding KB's fee. This worked out as follows:

10	Purchase price paid by KB for acquiring FRN	£30,024,000
	Less net present value of detached coupons 2-8	(2,411,416)
	Plus KB's fee	173,416
	Net consideration	£27,786,000

15 21. KB instructed EUROCLEAR, on 6 December 2001, to strip all the interest coupons from the ANZ FRNs with execution on 11 December 2001. EUROCLEAR's "Client Account" showed KB as entitled to the principal amount of £30,000,000 payable under the ANZ FRNs and to the coupons that were not part of the Flexi-Note product (namely Coupon 1 for interest on 12/12/01 and Coupons 9-12, being the four remaining coupons for interest 20 from 12/12/03 until 9/09/04). EUROCLEAR's "Proprietary Account" showed KB as entitled to Coupons 2-8.

25 22. Following KB's purchase of the ANZ FRN in the market, EUROCLEAR remained as registered legal owner, allocating the FRN and the Coupons (as just noted) to Proprietary and Clients accounts in KB's name. In KB's books the ANZ FRN was allocated to Mr Healey who, following the supply to him of the Flexi-Note product, is (the parties agree) to be regarded as the beneficial owner of that FRN. EUROCLEAR would have been unaware of Mr Healey's 30 involvement.

*Liquidation at the end of the term of the Flexi-Note*

35 23. 12 September 2003 was the term date for the Flexi-Note. On 5 August 2003, Mr Healey's advisers contacted KB by email and informed them that there was about £33.5 million [this included other FRNs than the ANZ FRN] to "mature" shortly. They asked about "the arrangements for the return of the funds" to Mr Healey's account, also asking what interest rate could be offered on funds left on account with KB and whether any replacement FRNs were available "on a 40 12 month maturity and longer if available to give us some options to consider". KB replied on 7 August, noting that Mr Healey would "begin to accrue interest from 12 August"; he could instruct KB to "liquidate" the FRN any time after that date at market value which was (as at 5 August) 100% of its face value of £30 million. Until KB received an instruction the FRN would "remain his" and 45 accrue interest at a rate linked to LIBOR.

24. Following Mr Healey's instructions, KB gave instructions to EUROCLEAR on 5 September 2003, in compliance with which the remaining coupons (9-12)

were reattached to the ANZ FRN. Again, following Mr Healey's instructions, on 12 September 2003 KB sold the ANZ FRN as agent for Mr Healey in the market for £29,997,000 (adjusted for accrued interest).

- 5 25. Mr Healey thus realised a profit of £2,211,000 on the ANZ FRN, being the difference between the sale consideration and his cost of £27,786,000.
26. We mention at this stage the evidence of Mr Jones, which we accept, that retention of the ANZ FRN following the end of the Flexi-Note Period would have involved a new investment decision based on the FRN being released from the constraints of the Flexi-Note.
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27. Mr Jones stated that, from his recollection, KB had never sold interest coupons that had been stripped and held in its proprietary account with EUROCLEAR. We note also that, in relation to all six FRNs relevant to this appeal, the execution date of the reattachment had been the actual date of the last coupon to which KB was entitled. Further, we have found no evidence that KB was obliged to secure reattachment of the remaining coupons at the term of the Flexi-Note. The brochure says that "*the investment may be liquidated*". We accept, however, that the expectation of all concerned with the product was that KB would duly give instructions to EUROCLEAR to reattach.
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***The profits from all the Flexi-Note products supplied to Mr Healey***

28. The total profits on the six Flexi-Note products, claimed to be profits on the disposal of QCBs was £8,680,000. HMRC have not claimed in this appeal that those profits were chargeable gains.
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***Legislation***

29. At the material time, section 18 of the Income and Corporation Taxes Act 1988 provided, so far as is relevant, as follows:
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"18 Schedule D

(1) The Schedule referred to as Schedule D is as follows –

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**SCHEDULE D**

Tax under this Schedule shall be charged in respect of –

- (a) The annual profits or gains arising or accruing –
- 40 (i) to any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere...
- (2) Tax under Schedule D shall be charged under the Cases set out in subsection (3) below, and subject to and in accordance with the provisions of the Tax Acts applicable to those Cases respectively.
- 45 (3) The Cases are –

- ...
- Case III: tax in respect of  
(a) any interest of money...  
(b) all discounts... “

5           ***The Case for Mr Healey***

30. Mr Healey contends that the gains on the disposals of the FRNs were not profits or gains arising from discounts from discounting transactions. The purchase of the particular FRN, he argues, was not a discounting transaction. The amount paid by him was not, to adopt the OED definition of the word “discount”, a “*deduction made from the amount of a bill of exchange or promissory note by one who gives value for it before it is due*”. The price Mr Healey had paid to acquire the FRNs had not simply involved a deduction from the principal amount secured on them, to reflect the fact that that principal amount was payable in the future; instead, he argued, it was a deduction from the market value of the FRNs to reflect the fact that interest coupons had been stripped for the Flexi-Note period.
31. Reliance was placed on the words of Lord Buckmaster in his speech in the House of Lords in *Leeming v Jones* 15 TC 333 at 357 where he said: “*All interest is expressly taxed by the words of the Rule, and discount is in reality only interest in another form and under another name*”. In common with interest, therefore, the defining characteristic of discount is (so the argument runs) that it represents a return for the use of money. In the present case the money had been “used” by the issuer of the FRNs (ANZ) which had provided a full return in the form of its interest obligations. In no sense, however, was what Mr Healey bought and sold a reward for the use of money.
32. Mr Healey further argued that the gains were of a capital, rather than an income, nature.

***Conclusions***

33. The subject-matter of the product supplied by KB to Mr Healey on 6 December 2001 comprised a bundle of rights and of expectations wrapped in a Flexi-Note. Following KB’s purchase of the ANZ FRN and the stripping instruction given to EUROCLEAR, KB had “unbundled” the FRN into 13 separate ingredients. Coupons 1 and 9-12 were allocated to KB’s Client Account with EUROCLEAR. Coupons 2-8 were allocated to its Proprietary Account. The FRN remained in existence but stripped of all coupons. Mr Healey’s rights, once he had become holder of the Flexi-Note, were to the “beneficial ownership” of the stripped FRN (giving him the right to repayment at par on 13 September 2004) and to Coupons 1 and 9-12. The product was designed such that, at the end of the Flexi-Note Period, KB could instruct EUROCLEAR to reattach Coupons 9-12 to the ANZ FRN. Mr Healey paid a price for those rights based on their net present value that reflected the absence of interest during the Flexi-Note Period (plus a fee for KB). No amounts were left

outstanding; no debtor-creditor relationship was created as a result of any of the transactions relating to the Flexi-Note product. The expectation was that Mr Healey would sell the FRN for a price equal (or very close to) to its maturity value. That, as noted, is what happened at the end of the Flexi-Note Period in September 2003.

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34. The function of the Flexi-Note product, as designed by KB and Mr Healey, was to compensate him for the loss of interest (due to KB's retention of Coupons 2-8) by providing him in return with a profit on sale or redemption of the ANZ FRN. KB made good its own "loss" (being the difference between what it paid for the ANZ FRN in the market and the consideration received from Mr Healey in December 2001) through its retention of Coupons 2-8. Thus, through the expedient of stripping the coupons on the ANZ FRN and the allocation of Coupons 2-8 to KB, the result was for the sale of the FRN to Mr Healey to take place at a price that was discounted to maturity. The interest, being the return for ANZ's use of the principal secured by the FRN, was diverted, for the duration of the term of the Flexi-Note, to KB as part of the deal between Mr Healey and KB. The value of the benefit obtained by Mr Healey from the deal was matched by the value of the interest on Coupons 2-8 enjoyed by KB.

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35. We have to determine whether the "profit" made by Mr Healey when, in September 2003, he sold his interest in the FRN, was a profit or gain "accruing or arising...from property" falling within the expression "all discounts" in section 18 of ICTA 1988. The authorities most directly in point are *National Provident Institution v Brown* [1921] 2 AC 222 and 8 TC 57, in the House of Lords ("*NPI*") and *Ditchfield v Sharp* (1983) 57 TC 555, in the Court of Appeal ("*Sharp*").

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36. The House of Lords in *NPI* had been concerned with what constituted a "discount" in the expression "all discounts" in the predecessor to section 18. The taxpayer had purchased at the Bank of England certain short-dated bills issued by the Treasury. The bills carried no interest but were issued at fixed rates of discount to their face value. The taxpayer had realised gains by holding some of the bills to maturity and by selling others before maturity. The point was established that the purchase of a Treasury bill from the Treasury was a transaction way of discount and that the whole profit, whether realised at maturity or through an earlier sale, was to be treated as an income profit. See Viscount Cave at 238 and Lord Atkinson at 253, who also observed that a factor of importance was that the amount secured by the bill had remained unaltered. Here, we note, the equivalent to the bill is the ANZ FRN and the amount secured by the FRN has remained unaltered irrespective of the Flexi-Note transaction.

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37. Lord Sumner, at 254 observed of the width of the statutory language that: "*The Rule...relates to 'profits' on all discounts from whomsoever made. There is no definition of discount in the statutes; no restriction of it to transactions in use in the year 1842; no evidence of its meaning as a term of art at any time*". Lord

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Atkinson observed in relation to the expression “all discounts”, at 250, that “the words are not happily chosen, but must, I think, be taken to mean, ‘all profits arising from discounts’”. Viscount Cave, at 238, considered that “the expression ‘profit on a discount’... is probably elliptical for ‘profit on a security bought at (or a transaction involving) a discount’”.

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38. The scope of Case III of Schedule D, taken generally is to tax compensation for the use of money to the extent that it represents profits or gains of an income nature and that it arises from a debt relationship. Specifically charged are interest and “all discounts”. The latter expression, to follow Viscount Cave’s words, covers profits on securities bought at a discount and profits on transactions involving a discount. Moreover, as Lord Sumner observed, the discount may be “*from whomsoever made*”. In the present case the alleged discount relates, albeit at one remove from Mr Healey, to a debt relationship, namely the original obligation assumed by ANZ to pay £30 million at maturity. Our analysis of the transactions between Mr Healey and KB is that they have, through the stripping operation, diverted ANZ’s continuing obligation to pay interest away from the beneficial ownership of the ANZ FRN. Coupons 2-8 have been retained by KB. The effect of the Flexi-Note, as already noted, has been to compensate Mr Healey for the diminishment in interest on the ANZ FRN by affording him the benefit of a “discount” in the sense that he pays less than the maturity value of the FRN when the Flexi-Note is supplied to him and receives an amount more or less equal to the maturity value at the end of the Flexi-Note Period.
39. On that basis, we think, the whole profit obtained by Mr Healey on termination of the Flexi-Note Period falls within the ambit of “discount” as explained in the speeches in the *NPI* appeal. The profit was attributable to the increase in the value of the ANZ FRN consequent on the stripping of all the coupons on 6 December 2001 followed by the reattachment of Coupons 9-12 on the term date. The transaction can, again using Viscount Cave’s words, be described as a profit on a security (the ANZ FRN) “bought at... a discount” and arising from a transaction “involving a discount”. The profit obtained by Mr Healey can, we think, be described as “interest in another form and under another name”, to use the words of Lord Buckmaster in *Leeming v Jones* (cited above).
40. Our review of the authorities so far leads to the conclusion that Mr Healey’s purchase of the Flexi-Note comprising ANZ’s undertaking to pay £30 million at the maturity date plus Coupon 1 and the onward sale of the ANZ FRN with coupons 9-12 reattached were discounting transactions. *Sharp* (in the Court of Appeal) concerned a taxpayer who, as here, had not been an original party when the debt relationship was created. A company (Bergers) had, in 1969, issued a promissory note promising to pay £2.4 million in 1973 with no interest. In 1970, the taxpayer trustees, together with others, purchased the note from the then holder, the trustees’ contribution being some £1.3 million; the note was held to maturity when the trustees received some £1.8 million. The

Revenue contended that the £500,000 gain was a discount of an income nature, chargeable to tax under Case III of Schedule D. The Court of Appeal agreed.

- 5 41. Fox LJ, at 684c-d of *Sharp*, observed that the note fell within the OED  
definition of discount which had been cited by Lord Atkinson in *NPI*  
(“discount...as used in commerce (1) is defined to mean a deduction (usually  
at a certain rate per cent) made for payment before it is due of a bill or  
account...(2) the deduction made from the amount of a bill of exchange or  
10 promissory note by one who gives value for it before it is due”). In the light of  
the wide interpretation given to the expression “all discounts” in *NPI*, the word  
cannot be limited to the instances in the OED definition. The decision of the  
Court of Appeal, as we read it, gives no support to the argument advanced for  
Mr Healey that a discount within section 18 of ICTA is limited to a situation  
15 where it represents a return for the use of money by the issuer of the note. The  
trustees, who were outside the debtor-creditor relationship created by the  
original issue, had bought the note at market value at a later date; it had not  
been their money that had been used by the issuer.
- 20 42. Had Mr Healey directly invested in this particular ANZ FRN with no stripping  
of coupons, there would have been no profit on a discount when he sold it. The  
use of the money was fully paid for by reason of the floating rate of interest.  
But here the situation is of KB, a third party to the original debt relationship,  
who has bought the “plain vanilla” version, divided it up it up and repackaged  
part of the ingredients for sale to a customer. The customer, Mr Healey, pays a  
25 price equal to the net present value of the covenants given by ANZ (to repay  
£30,000,000 in 2004 and to pay interest on Coupons 1 and 9-12) that he has  
bought as part of his Flexi-Note. There is no real difference between this case  
and *Sharp*. In both cases the debtor’s original covenants remain exactly as they  
were when the original debtor-creditor relationship was created. In both cases  
30 the third party purchaser for value pays a price that reflects the discount to  
maturity of the original debtor’s obligations. A difference (but not a  
determinative difference) is that, in *Sharp*, there was one single debtor’s  
obligation, namely to repay at maturity, while here ANZ has given covenants  
to repay at maturity and to pay interest in the meantime; and, for the purposes  
35 of the Flexi-Note product, some of the interest rights were not enjoyed by Mr  
Healey. The profit made by Mr Healey on sale in September 2003, with all the  
interest rights reattached, can nonetheless be described as a profit on a security  
bought at a discount.
- 40 43. The present Flexi-Note package is more complex than anything contemplated  
in *NPI* and *Sharp*. However, the effect of excluding Coupons 2-8 from the  
package in pursuance of the arrangement made between KB and Mr Healey  
was, for the reasons we have given, for Mr Healey, in purchasing the Flexi-  
Note, to have paid a discounted price for the FRN and to have obtained a profit  
45 on the security at the end of the Flexi-Note Period. That profit was a profit on a  
discount.

- 5 44. Turning now to the argument advanced for Mr Healey that the gains are of a capital, and not of an income, nature, we do not agree. In the first place this is at odds with reasoning in *NPI*. We refer, for example, to the speech of Lord Sumner at 253. Observing that the statutory words related to “profits” on all discounts from whomsoever made, he rejected the argument that the profits sought to be charged to tax were not profits on discounts because they were profits on realisation of investment, being accretions to the capital invested.
- 10 45. It must, in our view, be relevant to this question that FRN was a top-rated security as regards credit risk. It is, in the circumstances, hard to see that the return earned by Mr Healey was attributable to anything except the approaching resumption of interest once (as he knew and expected to happen) Coupons 9-12 were reattached. In *Lomax v Peter Dixon & Son* (1943) 25 TC 353 the Court of Appeal addressed the question of whether a discount of an income nature arose in a situation where a series of notes, issued in the mid-15 1930s at a discount and redeemable at a premium, were repaid. The issuer, a subsidiary of the lender, was a Finnish company and the funds to which the notes related had been used to build a manufacturing plant there. The terms of the notes reflected the high risk (of Russian invasion) to the lender’s capital investment in the borrower company. The Court of Appeal concluded that the profits on the discounts were not of an income nature and so were outside the scope of charge under Schedule D Case V. Lord Greene MR observed, at 363, that “*There can be no general rule that any sum which a lender receives over and above the amount which he lends ought to be treated as income. Each case must, in my opinion, depend on its own facts.*” Lord Greene went on to say that 20 all the surrounding facts must be taken into account and not just the bare terms of the contract document. Where, for instance, the credit of the issue was good, the investor’s return would be “*money for the use of money*”. But where the issuer’s credit and security are not good, there might be a discount together with a commercial interest rate. In that situation “*the defect in the security is expressed in terms of capital*”: see page 364.
- 25 46. Applying those principles to the present situation, where there was little adverse credit risk (and indeed the KB brochure stressed that very point) and where through no reason but the operation a scheme that Mr Healey had 35 entered into with (we presume) a full understanding of its features, he received no interest for almost all the period of holding the ANZ FRN, we cannot see the discount, which the arrangements were designed to create, as anything other than the return for the use of Mr Healey’s funds. The return had the character of income. Other features that reinforce this conclusion include the 40 brochure itself which stresses that that the product was designed to give an enhanced after-tax return significantly in excess of interest on fixed-term deposits. Moreover, the brochure offers the Flexi-Note package as a suitable investment for individuals *and their trustees*. The trustees would, if there were 45 competing claims between income and capital beneficiaries, be bound to treat the profit on the discount, or a large part of it, as income.

47. For all those reasons we dismiss the appeal so far as it relates to all six Flexi-Notes.
- 5 48. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to “Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)” which accompanies and forms part of this decision notice.
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15 **SIR STEPHEN OLIVER QC**  
**TRIBUNAL JUDGE**

**RELEASE DATE: 7 March 2013**

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## THE SCHEDULE

### Summary of the other five transactions

- 5           6 December 2001: Purchase of £30 million nominal of Woolwich FRN 12/8/04 for £28,125,000 and stripping of six coupons. On 4 March 2002: Purchase of £3,400,000 nominal of Woolwich FRN 12/8/04 for £3,226,600 and stripping of five coupons. In August 2003, both tranches were sold for £33,400,000.
- 10           12 December 2001; Purchase of £9 million nominal of Westpac FRN 14/6/06 for £8,232,300 and stripping of eight coupons. In December 2003 the FRN was sold for £9,006,300.
- 15           9 January 2002: Purchase of £20 million of Westpac FRN 14/6/06 for £18,194,000 and stripping of eight coupons. In March 2004, the FRN was sold for £20 million.
- 20           On 25 February 2002: Purchase of £22 million nominal of HBOS FR MTN 15/12/05 for £20,158,600 and stripping of eight coupons. In March 2004, the Note was sold for £22 million.