[2013] UKFTT 778 (TC)

TC02429

Appeal number: TC/2009/12118

CORPORATION TAX – Whether arrears of rent as between associated companies should be allowed on a bad debt, or disallowed for S74(1) ICTA 1988 – question of intention – Appeal Dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

SERE PROPERTIES LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE IAN HUDDLESTON
J.B. ADRAIN FCA

Sitting in public in Belfast on 25 June 2012

Jane Hodge, for HMRC

William Gould for the Appellant

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DECISION

5 ***Appeal***

1. This is an appeal by the Appellant, SERE Properties Limited, against HMRC's amendment to a Corporation Tax Return submitted by the Appellant for the accounting year ending 30 June 2012.

2. The amendment to the self-assessment arises from HMRC's refusal to accept a bad debt 10 of £798,330 as an admissible deduction from the Appellant's business profits for that accounting period pursuant to Section 74 of the Income and Corporation Taxes Act 1988 ("ICTA 1988").

Background Facts

3. The facts largely are not in dispute. SERE Properties Limited ("the Appellant") was 15 incorporated on the 3 September 1996, having its principal activity as one of property management. The directors and shareholders of the Appellant are Mr. Stanley Edgar (who appeared before the Tribunal to give evidence), and his wife Mrs. Rosemary Edgar.

4. The Appellant's parent company was, at the relevant time, SERE Holdings Limited, which again is owned by Mr. Stanley and Mrs. Rosemary Edgar.

20 5. Mr. and Mrs. Edgar also owned a separate company, SERE Motors Limited ("Motors") which was incorporated on the 4 July 2001 and began trading in January 2002. That company carried on the business of buying and selling new and used motor cars. It did not ultimately succeed and went into receivership on the 12 December 2003.

6. On the 1 August 2001 the Appellant entered into leases by which it demised various 25 business premises to Motors – those in the main being trading outlets for the sale of cars.

7. The Appellant's sole income during the account period ending 30 June 2003 was from the rent to which it thus entitled. In addition to the rent that fell due, there is a further £130,431 which the parties have now in fact agreed was a loan from the Appellant to Motors and which HMRC accept was admissible as a deduction. That loan was used to pay mortgage expenses 30 etc. to which the Appellant was subject.

8. After allowing for the loan, the net amount which constitutes the disputed bad debt is £798,330 ie. in respect of the accrued arrears of unpaid rent.

9. The Tribunal heard undisputed evidence that during the accounting period ended 30 June 2003 Motors was in financial difficulties, and that the directors received insolvency advice to 35 the effect that to continue to pay rent to the Appellant might be regarded as a preference that could lead them to being disqualified from holding further directorships.

10. The question, therefore, is whether the arrears of rent that was allowed to accrue should be deductable when applying the provisions of Section 74(1) ICTA.

11. That Section provides that no sum should be deducted in respect of:

> *"(a) Any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation ……..*
>
> *(e) Any loss not connected with or arising out of the trade, profession or vocation."*

HMRC's Case

12. HMRC's case is that the bad debt of £798,330 is not an admissible deduction from the Appellant's business profits on the basis that the Appellant did not allow the debt to remain unpaid and write it off "*wholly and exclusively for the purpose of [its business]*" in the sense required by Section 74(1)(a) and that it should be disallowed by virtue of Section 74(1)(e) as although it is a loss, it is not one that is "*connected with or arising out of*" the Appellant's property management business. HMRC say that the decision to allow rental arrears to accrue and then write them off was driven by motives wider than the Appellant's business.

13. HMRC contend that the principles enshrined in the case *Sycamore Plc and Maple Limited v Fir SpC104(1996)(at Paragraph 71)* apply viz that:

> *"Normally the treatment of a payment in the accounts should be applied, but only if such treatment follows the generally accepted rules of commercial accounting; if there is no statutory rule to the contrary; if such treatment is non inconsistent with the true facts; and if the true profit or loss of the trade is ascertained …."*

14. On that basis, applying Section 74(1)(e) HMRC says that the deduction is inadmissible, because it is not a loss connected with the property management business of the Appellant.

15. There is no dispute per se that the debt is bad, simply that it cannot be deducted in calculating the profits and losses of the Appellant because (and here I paraphrase) the decision to allow it to accrue, in essence, was governed by an objective wider than the business of the Appellant – namely the preservation of Motors' trading position.

16. Further, by virtue of Section 50(6) of the Taxes Management Act 1970, HMRC argue that the onus of proof is on the Appellant to show that it has been over charged by reason of the amendment to the tax computation, with the standard of proof being that which applies in civil cases such as this, ie. that it is proved on the balance of probabilities.

17. This line of argument obviously brings into question an assessment of the Appellant's objectives and, in that vein, HMRC referred us to a number of relevant cases.

18. We were first referred to *Roma L J* in the case of *Bentley, Stokes and Lowles v Beeson 33TC491 (1952)* where *Roma L J* said (at page 503):

"The sole question is whether the expenditure in question was "exclusively" laid out for business purposes, that is: what was the motive or objective in the mind of the two individuals responsible for the activities in question?"

19. We were also referred to the case of *Vodafone Cellular Limited and Others v Shaw 69TC376 (1997)* and in particular the comments of *Millet L J* in relation to the applicable tests:

"The words "for the purposes of the trade" mean "to serve the purposes of the trade". They do not mean "for the purposes of the taxpayer", but for the purposes of the trade, which is a different concept."

"To ascertain whether the payment was made for the purposes of the taxpayer's trade it is necessary to discover his object in making the payment. Save in obvious cases which speak for themselves, this involves an enquiry into the taxpayer's subjective intentions at the time of the payment."

20. Perhaps most helpfully of all, we were referred to the case of *Garforth v Tankard Carpets Limited 54TC342 (1980)* which was a case which involved two companies which shared the same directors, a situation similar to that before us. In that case, Walton J at P. 349 stated:

"It must, in the nature of things, be extremely difficult for any directors of two associated companies in the position of Carpets and JLT to be certain in whose best interests – or, rather, in whose exclusive interests – any step which they take is being taken. Obviously there is nobody but themselves to say what was in their own minds; and obviously, again, it must require a superhuman effort of mind (of which extremely few persons, if any, are capable) to rule out entirely from consideration the possibility of benefit to one's other company when concentrating on the exclusive requirements of just one of them …."

21. On the basis of that case law HMRC suggests that this Tribunal must consider the Appellant's objective in not collecting the rents as distinct from the effect of its decision not to collect them.

22. On the facts of the case, they suggest that the objectives of the directors of the Appellant was primarily to help Motors:

(1) because, as directors and shareholders in Motors, they were aware of the poor trading condition of Motors' finances, and that forbearance was intended to help Motors' continuing, albeit weak, trading;

(2) that the directors' objective in allowing Motors not to pay rent was, on the advice of its professional advisers, to avoid the rent being considered a preferential payment in any subsequent insolvency, and thus focused on preventing them becoming involved in any subsequent disqualification proceedings that might arise on the insolvency of Motors;

(3) that as a result the directors must have considered the interests of both companies together when they decided not to collect, and then subsequently write

off, the debt which had accrued to the Appellant and that, therefore, applying the principles set out in *Tankard* (supra) that it is difficult for directors, who hold directorships common to both companies and, indeed, are the controlling shareholders of both, to distinguish the purposes of one company from those of the other and that on the particular facts of this case that they have failed to discharge the burden upon them (as set out in *Tankard*).

The Appellant's Case

23. The Appellant's case was presented by Mr. William Gould of Exchange Accountancy Services Limited who called Mr. Stanley Edgar to give evidence.

24. It was very clear from that evidence that at all material times through the accounting period in question that Motors was in a financially precarious state.

25. Evidence was given that there was some prospect of an improvement in that arising from, firstly, the potential successful outcome of a Criminal Damage Claim in relation to a former site and, secondly, the possibility of a claim against HMRC for recovery of VAT arising out of cars which had been used as demonstrators.

26. It was accepted by the Appellant that insolvency advice had been provided and that it, in turn, had counselled against the payment of rent lest it be considered as a preference.

27. The evidence which Mr. Edgar provided to the Tribunal was that Motors simply did not have the cash to pay the rent, and that there was no alternative for the Appellant but to stop demanding it in the hope that if profitability returned that there would be a possibility that the arrears of rent would then be discharged – particularly if the Criminal Damage and VAT claims were resolved to the benefit of the Appellant. The argument advanced was that the Appellant had, in effect, resolved to take the longer view.

28. Ultimately, however, the withdrawal of certain motor franchise agreements and a straightening working capital position led to Motors entering into receivership in December 2003.

29. At all times Mr. Edgar asserted that the companies were operated independently of one and other and treated separately, and in support of that he cited, in particular, the procurement and then adoption of insolvency advice in his capacity as a director of Motors at a point when that company ceased to make payments of rent to the Appellant. The resulting loan amounts were applied to then satisfy the Appellant's obligations (eg. mortgage payments) and were satisfied in full on the sale of the various properties.

30. In support of that position, he also advised the Tribunal that VAT relief had been allowed on the bad debt. That of course involves very different circumstances from those before in the consideration of this Appeal.

Decision

31. I have already set out above the requirements of Section 74 and do not repeat them here.

32. As HMRC have correctly identified, where an Appellant, such as the Appellant, wishes to apply a deduction, then it must equally establish that it is a deduction which is not prohibited by the operation of that Section.

33. In that regard, the onus of proof is upon the Appellant.

5 34. On the facts of this case we have two companies which are intimately connected – in some ways more intimately connected than was the position in the *Tankard* case. As suggested by that case, it therefore behoves the Appellant to be even clearer in the evidence which it adduces to this Tribunal to establish that an expense, which has a collateral benefit to an associated company, is properly treated as an expense of the taxpayer (the Appellant in 10 this case).

35. To establish that, the Tribunal has obviously heard Mr. Edgar as to what was subjectively in his mind at the relevant time. That he has attempted to do through this oral testimony, but as he himself acknowledges, there is no supporting documentation, for example contemporaneous minutes etc. to support the decisions that were taken. Minutes were 15 certainly referred to both in Mr. Edgar's witness statement and his oral testimony, but could not be produced.

36. It does equally behove the Tribunal to look objectively at the entire circumstances.

37. In that regard, it is stretching the imagination to suggest that the decision to forego rent was driven by anything other than a desire by the common directors to ensure that Motors, as 20 the cash generating vehicle, was allowed breathing space within which to put its affairs in order.

38. In the circumstances, and having heard Mr. Edgar's evidence, the Tribunal finds that that was, in fact, the predominant purpose. Indeed, Mr. Edgar said as much in his evidence. His hope and aspiration was that by providing some latitude in favour of Motors that the two 25 outstanding claims which he described would come to fruition or, possibly more optimistically, that the company would be allowed to trade out of its difficulties, at which point it would then be able to discharge the arrears of rent.

39. To the Tribunal's mind, that can only be interpreted as a predominant intention to benefit Motors at the expense of the Appellant.

30 40. In those circumstances, and giving Section 74 its natural meaning, we fail to see how it can sensibly be concluded that the subsequent claim for bad debt relief is not disallowed by virtue of the application of the provisions of Section 74(1)(e), which requires (broadly speaking) that for a loss to be deductable that the Appellant's sole purpose for not collecting, and then subsequently writing off the debt, must be for its own business purpose.

35 41. Having reached that conclusion, it naturally follows that the Appeal is dismissed and that the sum of £798,330 is not an admissible deduction in the calculation of the Appellant's business profits for the accounting year in question. That re-statement results in a revision of profits to £733,872 and a corporation tax liability of £219,718.08.

42. If you are dissatisfied with the outcome of the application for permission to appeal the decision in this appeal, either party has the right to apply to the Upper Tribunal for permission to appeal. Such an application must be made in writing to the Upper Tribunal at 45 Bedford Square, London, WC1B 3DN no later than one month after the date of this notice. Such an application must include the information as explained in the enclosed guidance booklet "Appealing to the Upper Tribunal (Tax and Chancery Chamber)".

IAN HUDDLESTON

TRIBUNAL JUDGE

RELEASE DATE: 12 December 2012