[2018] UKFTT 341 (TC)

# TC06556

**Appeal number: TC/2017/03196**

*Corporation tax – loan relationships – loans made to borrower company unable to repay them – whether a "loan relationship" – ss 302 & 303 Corporation Tax Act 2009 – appeal allowed*

**FIRST-TIER TRIBUNAL**
**TAX CHAMBER**

**C J WILDBIRD FOODS LIMITED** **Appellant**

**-and-**

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

**TRIBUNAL**: **JUDGE KEVIN POOLE**

**Sitting in public in Centre City Tower, Birmingham on 14 June 2018**

**Michael Stean, RSM UK Tax and Accounting Limited, for the Appellant**

**Daniel Baird, Presenting Officer of HM Revenue and Customs, for the Respondents**

DECISION

## Introduction

1. This appeal concerns a series of inter-company loans advanced by the appellant to a company in which it held a 50% share over the years ended 31 March 2013, 2014 and 2015. These loans followed previous similar loans advanced over the previous 6 years or so. The issue in dispute in the appeal was whether, as a result of these loans and in the light of the surrounding circumstances, the appellant had loan relationships in respect of them for the purposes of Part 5 of the Corporation Tax Act 2009 ("CTA"), such that a debit should be allowed to it in respect of the impairment of those loan relationships.

## The facts

2. I heard evidence from Antony Cordery (director of the appellant), Stephen Kirk (director of Birdforum Limited ("BFL")) and Alan Tudor, an Inspector in HMRC's Mid-sized Business Team. None of this evidence was seriously challenged. Mr Tudor did little more than confirm his written witness statement (which largely set out an uncontentious history of HMRC's enquiries). Mr Cordery gave an account of the history of the transactions of the appellant involving BFL and Mr Kirk gave a slightly more detailed account of the business and activities of BFL. All were clearly straightforward and honest witnesses. I also received bundles of documents prepared by the parties.

3. I find the following facts.

4. The appellant has at all material times carried on business in the wildlife sector. It started out in 1987 as a supplier of specialist birdseed for wild birds, achieving a turnover of £1.7 million by 1994.[1] In looking at various opportunities to develop the business, Mr Cordery met Mr Kirk at the British Birdfair on Rutland Water in August 2004. Mr Kirk had developed and launched a website called Birdforum by that time, whose aim was to develop a worldwide community for birdwatchers and general ornithology. He was looking for investment to expand.

5. After lengthy negotiations, an arrangement was agreed. The appellant took a 50% shareholding in BFL, the company through which the website was then operated, with Mr Kirk continuing to hold the other 50% interest. BFL was clearly likely to need further working capital beyond the £100,000 invested by the appellant in BFL share capital, so provisions were incorporated into the shareholders' agreement (signed on 4 May 2005) which included the following terms:

> "**5. Funding and development**
>
> 5.1 The Company and the Business shall initially be financed by the share subscription referred to in clause 4.5.

[1] Its turnover has since increased to approximately £20 million

5.2 CJW shall make the Investors' Loan[2] available to the Company on the following terms:

5.2.1 The Investors' Loan shall be a working capital facility which without prejudice to clause 5.2.6 and subject to clause 5.4 shall be repayable on demand;

5.2.2 Drawdown of the Investors' Loan shall be by notice in writing to CJW (whether in electronic form or otherwise) to CJW in accordance with the Annual Business Plan[3];

5.2.3 Interest shall accrue at a rate of 2% above the Bank's base rate from time to time per year from 1 April 2010 ("the Interest Date") on a daily basis on the balance remaining of the principal outstanding as at 1 April 2008 and any interest which remains unpaid following the due date for payment. Any further principal advanced after 1 April 2008 will bear interest from that date;

5.2.4 From the Interest Date the Company will make interest payments in arrears on each Quarter Day in each year in respect of the period ending on but excluding that date with the first payment being due on the Quarter Day following the Interest Date in respect of the period from and including the Interest Date but excluding the date of payment.

5.2.5 Subject to the agreement of the Board, the Company shall be entitled to repay the Investors' Loan in full or in multiples of £100 at any time after Completion.

…

[There followed detailed provisions concerning repayment on insolvency and various other events, and methods of payment.]

…

5.4 Notwithstanding that CJW shall be entitled to demand repayment of the Investors' Loan at any time, CJW covenants that other than in the circumstances set out in clause 5.2.6 it shall only demand such repayment following discussion with the Board."

6. BFL had by then signed a three year sponsorship agreement with Zeiss, the German optical equipment group, which afforded income of £38,000 per year.[4] It

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[2] Defined as "the loan of such sum as is agreed to be made available by CJW to the Company pursuant to clause 5 and the amount of such loan from time to time."

[3] No such plan was ever produced. In the changed circumstances, it was not thought to be worth the effort.

[4] In evidence, we were informed the income was £40,000 per year, but the copy of the agreement dated 1 October 2004 contained in our bundle referred to £38,000. The difference is inconsequential.

appears that Zeiss withdrew from this agreement almost immediately following the involvement of the appellant, apparently due to some personal clash between someone from Zeiss and another director of the appellant. There was also a very short-lived arrangement with Zwarowski Optik in late 2007 which yielded some small income.

7. The appellant decided to continue supporting BFL by continuing to advance payments to it to cover its running costs while further possibilities were explored for creating income or value from it. Some value was derived from the appellant's investment by using the Birdforum website for marketing and other matters. BFL employs 4 staff and incurs significant internet server costs in relation to the platform on which its website runs. In a typical year, the overall cost of running BFL is approximately £150,000 and this figure has remained fairly constant over the years. It has not generated any material income since the loss of the Zeiss and Swarovsky contracts. It has however become very successful as an internet forum. It has 155,000 current members, which (according to Google Analytics) makes it the largest birding forum (if not wildlife forum) in the world.

8. By 31 March 2015, the amount of the accumulated debt due from BFL to the appellant was £1,517,643. In the years to 31 March 2013, 2014 and 2015, advances to it by the appellant were £151,188, £150,388 and £150,388 respectively. No interest has ever been paid by BFL nor has it ever repaid any of the money advanced to it. As BFL would be entirely unable to pay interest, none has been accrued in the accounts of either company; the understanding is that if and when it is possible to generate income in BFL or sell it, the debt and accrued interest will be paid out before any remaining funds are shared between the shareholders.

9. Mr Cordery and Mr Kirk have regular weekly phone conversations about BFL. There have been some offers to acquire it, but they have either been withdrawn by the counterparties or rejected by BFL as too low. Other means of raising income from the Birdforum website have been discussed, including the possibility of charging subscriptions; given the current size of the membership, it would not require a very large subscription to make the forum profitable. Also, appeals for voluntary donations have been made, but met with limited success. BFL's anxiety is over whether the introduction of subscriptions might sharply reduce the number of members and therefore undo all the progress that has been made since 2005. The relationship between BFL and the appellant, while friendly, is nonetheless arms' length. I am satisfied that the appellant is providing the support to BFL for its own commercial reasons.

10. In each of the corporation tax returns for the years ended 31 March 2013, 2014 and 2015, the appellant claimed a non-trading loan relationship debit equal to the amount of the loan advanced during that year, on the basis that the loan was unlikely to be recoverable "in the short term" and it was therefore fully provided for in the appellant's accounts. HMRC do not dispute this accounting treatment (subject to the wider issues considered in this appeal).

11. In due course, HMRC opened enquiries into the appellant's corporation tax returns for the three years in question and ultimately closed those enquiries by

amending the returns to add back the loan relationship debits referred to above. The appellant appealed to the Tribunal.

**Relevant legislation**

12. The relevant statutory provisions are, so far as pertinent, as follows.

13. Sections 302 and 303 CTA provide, in relevant part, as follows:

> "**302 'Loan Relationship', 'creditor relationship', 'debtor relationship'**
>
> (1) For the purposes of the Corporation Tax Acts a company has a loan relationship if –
>
> (a) the company stands in the position of a creditor or debtor as respects any money debt (whether by reference to a security or otherwise), and
>
> (b) the debt arises from a transaction for the lending of money.
>
> (2) References to a loan relationship and to a company being a party to a loan relationship are to be read accordingly.
>
> …
>
> (5) In this Part 'creditor relationship', in relation to a company, means any loan relationship of the company where it stands in the position of a creditor as respects the debt in question.
>
> (6) In this Part 'debtor relationship', in relation to a company, means any loan relationship of the company where it stands in the position of a debtor as respects the debt in question.
>
> **303 'Money debt'**
>
> (1) For the purposes of this Part a money debt is a debt which –
>
> (a) falls to be settled –
>
> (i) by the payment of money,
>
> (ii) by the transfer of a right to settlement under a debt which is itself a money debt, or
>
> (iii) by the issue or transfer of any share in any company,
>
> (b) has at any time fallen to be so settled, or
>
> (c) may at the option of the debtor or the creditor fall to be so settled.

…

(3) A money debt is a debt arising from a transaction for the lending of money for the purposes of this Part if an instrument is issued by any person for the purpose of representing –

(a) security for the debt, or

(b) the rights of a creditor in respect of the debt."

14. For the purposes of these provisions, section 476 CTA provides that "'loan' includes any advance of money and related expressions are to be read accordingly".

**The issue**

*HMRC's arguments*

15. The only remaining ground upon which HMRC seek to rely in disallowing the debits (various other arguments, including an "unallowable purpose" one, have been raised in the past, but all have been dropped) is that there is no "loan relationship" between the appellant and BFL.

16. In Mr Baird's submission, the arrangements between the appellant and BFL did not amount to a loan relationship at all within section 302 CTA because neither of the conditions in subsections 302(1)(a) and (b) were satisfied.

17. He submitted there was no "money debt" between the appellant and BFL because, in his submission, any amount owing would have to "bear the hallmarks of a loan" in order to fall within the definition of "money debt" within section 303 CTA; the arrangement as described by the appellant amounted in his submission to the appellant arguing that these were "contingent loans", repayable only if BFL managed to make a profit. In his submission, however, it was "not a loan, contingent or otherwise, as it does not carry the hallmarks of a loan, which are that it is repayable, it carries interest, is an ordinary business transaction, etc."

18. In support of this submission, he cited *Smart v Lincolnshire Sugar Limited* (1937) 20 TC 643, in particular the comments in the Court of Appeal by Lord Wright MR, where he contrasted a "loan" with a "payment of money subject to a contingent liability in certain events to repay" in very limited circumstances. In *Smart*, there was no "firm or unqualified obligation to repay", there was no interest involved, and it certainly was not "an ordinary mercantile transaction of loan"; it was instead a subsidy. In his submission, *Smart* was authority for the proposition that before a contingently repayable amount could be regarded as a debt, it had to have "the hallmarks of a loan: for example, if evidenced by a debt instrument, carries interest, ranks above share capital in a liquidation, and so on."

19. In his submission, those hallmarks (or crucial parts of them) were absent in this case. First, it was clear that interest had never been charged or paid on the advances that had been made. Second, BFL had not made a profit since the appellant became

involved with it and it did not have the capacity to repay the advances, or any credible plan how it might do so. The annual advances and immediate write-offs in the appellant's accounts constituted another clear indicator that there was not a true loan relationship. In short, he submitted this was not an arm's length transaction bearing any resemblance to the commercial reality of a loan relationship.

20. As to the actual nature of the advances, he submitted they could only be one of three things: a fee, a gift, or a payment akin to a capital contribution. He discounted the first of these possibilities, given the accounting treatment of it in BFL's accounts. He seemingly considered the second possibility unlikely, though without really explaining why; all that he said was that if the advances were gifts then they should be disallowed as having not been paid "wholly and exclusively for the purposes of the [appellant's] trade" (see section 54(1)(a) CTA). His preferred analysis was that they were payments akin to capital contributions, therefore disallowable under section 53(1) CTA; this was because they "bear the hallmarks of equity rather than debt. Therefore there is no loan relationship."

*The appellant's arguments*

21. On behalf of the appellant, Mr Stean in summary argued that both the way in which the advances were documented and accounted for and the evidence of Mr Kirk and Mr Cordery made it quite clear that we were here concerned with money debts. Advances of money had been made, with corresponding obligations to repay. If BFL was able to pay it, the accrued interest would also be charged. All that HMRC were challenging was BFL's ability to discharge its obligation to repay. That was not a ground for recharacterising a debt as something else. Even if it were appropriate in some way to consider the obligation to pay in combination with the ability to discharge that obligation it was stretching the *ratio* in *Smart* much too far to say that it prevented the relationship in this case from being properly regarded as a "debt" arising from "a transaction for the lending of money".

**Discussion and decision**

22. There is no doubt, on the evidence before me, that the advances made by the appellant to BFL are, in law, repayable with interest. The advances are shown in BFL's accounts as due and owing, and whilst they have been provided for in full in the appellant's accounts, they have not been legally written off, i.e. formally released.

23. As to interest, there is a clear contractual agreement between the parties that interest is payable at an agreed rate on the moneys advanced. There has been no waiver of that arrangement, only an agreement that there is no point in the interest actually being charged unless and until funds are available to pay it.

24. Whether or not the advances have technically fallen due for repayment, it is clear that the appellant and BFL have agreed that such repayment need not be made for the time being. Even if such agreement had not been reached, there would be no change to the legal status of the advances as debts due from BFL to the appellant simply because of the appellant's failure to require repayment.

25. I consider it therefore to be quite clear that the amount payable by BFLto the appellant in respect of each advance amounts to a "money debt" for the purposes of section 303 CTA. It is irrelevant whether there is any instrument of the type referred to in subsection 303(3) CTA as there is no requirement for such an instrument to exist before it can properly be said that a money debt is a "debt arising from a transaction for the lending of money for the purposes of this Part".

26. Accordingly, the condition in subsection 302(1)(a) CTA is clearly satisfied in relation to the advances involved in this appeal. Mr Baird's argument, properly understood, can therefore only relate to the satisfaction of the condition in subsection 302(1)(b) CTA.

27. The question to be answered therefore is whether each of the debts which arose in consequence of the advances arose "from a transaction for the lending of money".

28. In view of the legal nature of the transactions between the appellant and BFL, there is no doubt that the making of each advance amounted to "a transaction for the lending of money", subject only to the question of whether it ought to be recharacterised as something else pursuant to the decision in *Smart*.

29. It is therefore necessary to examine that decision in more detail.

30. *Smart* involved an examination of a cash payment made to a sugar company; the issue was whether the payment was by way of a trading subsidy from the government (and therefore to be brought into account as a trading receipt in computing profits) or by way of a loan (and therefore not so brought into account).

31. The nature of the payment was complex. Under an Act of Parliament passed in 1925, certain subsidies were paid to sugar manufacturers in the UK in respect of sugar manufactured by them from sugar beet grown in the UK. The subsidy lasted for ten years from 1 October 1924. As the subsidy reduced towards the end of the ten year period, but the market price of sugar fell, sugar manufacturers found themselves again in difficulties. In 1931 a new Act was passed to provide further support. That Act provided for weekly cash "advances" to be made for a one-year period from 1 October 1931 to sugar manufacturers, to support them in buying sugar beet from UK growers at prices not less than those specified by Parliament. If the market price of imported sugar was such that the manufacturer qualified for subsidies under the 1925 Act, then there was a formula for repayment, by deduction out of those subsidies, of some or all of the payments made under the 1931 Act. If a manufacturer became insolvent, then all the payments under the 1931 Act became repayable. Otherwise, to the extent not "clawed back" by deduction from the subsidies paid under the 1925 Act, the manufacturer was not required to repay the advances under the 1931 Act at all. In the event, none of the advances fell to be repaid.

32. In the High Court, Finlay J was clearly in some doubt about the outcome (describing it as "a case of considerable difficulty", and one in which he "indicated, though not without doubt, that I agree with [the Special Commissioners]"). He decided that the advance made to the company was a loan. The Court of Appeal disagreed, and

the House of Lords unanimously agreed with them, holding (at p 671) that the advances "were intended artificially to supplement their trading receipts so as to enable them to maintain their trading solvency"; as such, they ought to be "taken into account in computing the balance of the Company's profits and gains" for the year in which they were received. What Lord Macmillan (delivering the unanimous opinion of the House) said (at p 670) was "decisive" was that "these payments were made to the Company in order that the money might be used in their business".

33. The analysis in the House of Lords did not go much further than that, and it is the judgment of Lord Wright MR in the Court of Appeal (upheld by the House of Lords) which contains more consideration of the issue, to which Mr Baird referred me.

34. After summarising the arguments of the parties and the background facts, Lord Wright (giving the leading judgment) referred (at p 659) to the case as being "clearly in its nature quite anomalous; it is not an ordinary mercantile transaction of loan; it is in truth a statutory bargain, and all the circumstances have to be borne in mind." He went on to say this:

> "That money [i.e. the advance under the 1931 Act] was paid in respect of a limited period, and it was only to be repaid if the difficulty which led to it being paid in the first instance, namely, the fall in the price of sugar, was surmounted during the remaining years of the currency of the Act of 1925. The two things were bound up together, and under those circumstances the repayment which was provided was not such as one would expect in any case of a loan, nor were the terms of the Act such as one would have expected in the case of a loan. There was to be a very limited payment by the reimbursements in a very limited state of things, namely, if the need for this additional assistance during the period up to 1934 had ceased to operate. Now so far, to my mind, this very peculiar and anomalous state of things bears no resemblance to a loan at all. I think it is a payment of money subject to a contingent liability in certain events to repay, or perhaps more strictly, to submit to a deduction, in the very limited circumstances which I have specified, of an amount which might or might not, if it ever eventuated, come in any way within the same sums as the amounts which were paid.

35. Romer LJ agreed, saying this:

> "Now it is true that the sums in the Act of 1931 are referred to as advances. It matters not, to my mind, what the Legislature calls these sums. What we have to ascertain is what in truth and in fact they are. Looking at the Act, and construing it to the best of my ability, I arrive at the conclusion, notwithstanding the use of the word "advance", notwithstanding the provisions in a certain even for repayment, that these sums are in truth and in fact subsidies…"

36. In HMRC's Corporate Finance Manual at paragraph CFM31030, Mr Baird pointed to the following commentary on *Smart*:

> "Lord Wright, in the Court of Appeal, said that the subsidy had none of the 'marks' of a loan. Not only was there no "firm or unqualified

> obligation to repay", it did not carry interest, and was not an "ordinary mercantile transaction by way of loan".
>
> On this basis, a contingently repayable amount is likely to be a debt – and hence a money debt within CTA09/S303 – if it has the hallmarks of a loan: for example, if evidenced by a debt instrument, carries interest, ranks above share capital in a liquidation, and so on. Accounting treatment may be one of these 'marks', but is not in itself decisive."

37. In fact, this commentary misrepresents what Lord Wright actually said. The only one of the above comments he adopted was to the effect that the particular transaction under consideration in *Smart* was "not an ordinary mercantile transaction of loan", a statement which is self-evidently true. All the other statements attributed to him in the above commentary were merely his rehearsal of the arguments put forward on behalf of the Crown, none of which he specifically endorsed (though, from his overall description of the scheme, he clearly accepted there was no "firm or unqualified obligation to repay"). The reasons he actually gave are set out at [34] above.

38. *Smart* represents the best authority Mr Baird can provide for his argument, but there are too many obvious differences between the cases for it to bear the weight he would place upon it. *Smart* was considering the contrast between a loan and a complex scheme of statutory subsidies which contemplated from the outset that some or all of the relevant payments would never fall due for repayment. It was also considering the tax position of the debtor company (not the creditor company) for the purpose of computing its taxable trading profits over sixty years before the loan relationship rules were introduced.

39. What Mr Baird's argument essentially boils down to is this: given that, at the time each relevant payment was advanced, BFL could not have repaid it (or the interest on it) and had no plausible plan for doing so, it cannot properly be said that the resultant debt "arises from a transaction for the lending of money" for the purposes of subsection 302(1)(b) CTA.

40. I disagree. The modern business world has many famous examples of companies, especially in the technology sector, with no cash and no immediate prospect of generating a profit which go on to be very successful. Clearly the appellant considers BFL potentially to be such a company and is therefore prepared to subsidise its running costs by way of loan for the time being in the hope of obtaining repayment of some or all of its loans in due course, possibly with a gain on its share investment as well.

41. As to the "hallmarks" that Mr Baird asks me to consider, there is no requirement that for a loan relationship to exist, interest must be charged; were it otherwise, many perfectly normal intra-group loans would fall foul of that requirement (and in any event, the loans in this case include a contractual obligation to pay interest, albeit an obligation that has not yet been enforced). Nor is there any requirement that, for a loan relationship to exist, the lender must have any degree of certainty that the debt will be repaid – normal commercial loans are inherently hedged about with uncertainty about whether repayment will be made and save in degree, the present situation is no different. Lack of a fixed repayment date for a loan is perfectly commonplace. Here, the money has

been advanced by the appellant on terms that it is all to be repaid. The fact that such repayment has not been made and HMRC may have formed the opinion that these payments will never be repaid is beside the point. The loans have been advanced as a matter of arm's length negotiation between the two parties, there is an obligation to repay (as recognised by both companies in their respective audited accounts and confirmed in evidence), and the fact that the appellant may well not recover some or all of its money is neither here nor there. It has made a commercial judgment that it is in its best interests to continue to support BFL by continuing loans, and the fact that HMRC may disagree with that judgment is irrelevant to the underlying nature of the transaction. Ultimately it may turn out that the appellant's business judgment was overly optimistic, but that is of no relevance.

42. It follows that I find the transactions in question to amount to loan relationships of the appellant within section 302 CTA and the appeal is therefore ALLOWED.

43. 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.

**KEVIN POOLE**
**TRIBUNAL JUDGE**

**RELEASE DATE: 22 JUNE 2018**