ICTA 1988 s.419(1) - investment company - loans in ordinary course of business

THE SPECIAL COMMISSIONERS

THE DEANBY INVESTMENT CO LTD Appellant

- and -

JAMES JOSEPH BRENNAN

(HM INSPECTOR OF TAXES) Respondent

Special Commissioner: MR B M F O'BRIEN

Sitting in public in Belfast on 7 February 2000

Mr J D McCaughey on behalf of the Appellant

Mr M S Curry, H M Inspector of Taxes, on behalf of the Respondent

DECISION

1. This is an appeal by The Deanby Investment Co Ltd ("Deanby") against an assessment made under section 419(1), Income and Corporation Taxes Act 1988, for the company's accounting period ending 28 February 1998. The amount of tax due under the assessment is £7,500, and the liability is alleged to arise by reason of a loan of £30,000 made by Deanby on or about 1 September 1997 ("the 1997 loan") to Mr J D McCaughey ("Mr McCaughey").

Section 419(1) provides:

"... where a close company, otherwise than in the ordinary course of a business carried on by it which includes the lending of money, makes any loan ... to an

individual who is ... an associate of a participator, there shall be [due] from the company, as if it were an amount of corporation tax chargeable on the company for the accounting period in which the loan ... is made, an amount equal to such proportion of the amount of the loan ... as corresponds to the rate of advance corporation tax in force for the financial year in which the loan ... is made,"

It is common ground that Deanby is a "close company" and that Mr McCaughey was "an associate of a participator" as defined for the purposes of this provision. The sole question for my decision is whether the 1997 loan fell outside the charge by reason of the words which I have underlined.

2. As its name suggests, Deanby is an investment company. It was incorporated in Northern Ireland in 1926 by Mr McCaughey's late father, who was an estate agent. The company's Memorandum authorises the lending of money. Two further companies were also incorporated, "Barr" and "Camden": as I understand it, they were indistinguishable in character from Deanby. Throughout the period under review in this appeal, the issued capital of each of the three companies was £25,000, and each of the companies held a 37% interest in each of the others. The remaining 26% in each was held by Mr McCaughey's wife and daughters. Mr McCaughey, his wife and daughters constitutes the boards of the three companies, Mr McCaughey being the Chairman (and clearly carrying out the duties of Managing Director).

3. Initially, and for many years, Deanby's (and the other `companies') capital assets consisted for the most part of domestic property from which they derived rents. However, in 1956 Deanby purchased a ground rent and took over an associated outstanding loan. That loan was not, of course, actually made by Deanby; but its existence in the portfolio demonstrates that the company was content to hold such an interest-bearing asset among its investments. That loan was not paid off until 1963. The acquisition of these property assets was funded, to some extent at least, by borrowing from banks or building societies.

4. During the lifetime of Mr McCaughey's father, the day-to-day management of the three companies' affairs formed a natural part of his estate agency business. But Mr McCaughey himself was (until he retired in 1991) a structural engineer and a partner in the consultancy firm of Kirk McLure Morton. Rented properties ceased to be a convenient form of investment. At the same time, Mr McCaughey was required, almost on an annual basis, to introduce capital into the partnership. In or about 1978 the directors of the three companies decided to dispose of the rented properties, thus releasing surplus liquid funds available for lending to Mr McCaughey. In that way a portion of Mr McCaughey's capital requirements in relation to the partnership could be met. Mr McCaughey could always afford to offer a more than satisfactory rate of interest on money borrowed from any of the three companies, not only because the interest would be retained within the family but also because it would qualify for relief under sections 353 and 362, Income and Corporation Taxes Act 1988.

5. Shortly afterwards, Mr McCaughley took a loan of £16,328 from Barr. I infer from page 25 of the documents presented by Mr McCaughey that Barr's properties were the first to be sold, because although Mr McCaughey took a loan of £8,026 from Camden in 1980, this may well have been funded in fact by a transfer from Barr. There were interest-free loans from Barr to both Camden and Deanby between 1979 and 1982. It is clear that Mr McCaughey took loans from both Barr and Camden on several occasions during he 1980s.

6. The first loan by Deanby was made in the year to 28 February 1983 (£2,980, to Mr McCaughey). That preceded any property sale by Deanby, and how exactly it was funded is not in evidence; but Deanby's indebtedness to Barr in 1982 amounted approximately to the same sum. Further loans were made by Deanby to Mr McCaughey in the years to 28 February 1984, 1985, 1986, 1988 and 1990; and on 1 November 1990 one of no less than £81,000 (through that was shortly afterwards reduced to £31,000, the balance being provided by loans from Barr and Camden).

7. Prior to November 1990 none of the loans was made pursuant to a written offer and acceptance : the documentary evidence is contained in the three companies' accounts only. None of them was secured. However, Mr McCaughey's partnership arrangements provided for the repayment of the entirety of his capital upon his retirement; he was satisfied that that capital was not insecure; and in all the circumstances, his knowledge of the absence of risk should clearly be ascribed to Deanby and the other two companies themselves.

8. Mr McCaughey retired from the partnership business in 1991 and his borrowings from Deanby were completely repaid by 14 December 1993. (His borrowings from Camden and Barr were repaid in the previous and the following years respectively).

9. During the ten years 1984/85 to 1993/94 the interest paid by Mr McCaughey to Deanby, which amounted in total to £38,183, exceeded the total net profits of the company and contributed some 58.7% of its turnover.

10. On 1 February 1994 Deanby made a loan of £5,000 (at 3½% above Bank of England Minimum Lending Rate) to Glendinning McLeish & Co Ltd. This was not a McCaughey family company, but Mr McCaughey had become acquainted with it in his professional capacity, and at the time of the loan was the Chairman of its board (and a small minority shareholder). That loan was repaid in July 1998. This was the only loan actually made by Deanby outside what might be described as the immediate family circle. Deanby never held itself out in any public fashion as a provider of loans.

11. As the McCaughey loans were repaid, Deanby reacquired substantial liquid funds, and it purchased shares (in three companies, I believe). The notes to Deanby's accounts for the year to 28 February 1998 show investments (other than loans) as at February 1997 valued at some £130,000. They included shares in Stranwood Estates Ltd. Mr McCaughey wished to acquire £40,000 worth of these for himself, the purchase price being provided by Deanby by way of a new loan; but he was on notice that the Inspector of Taxes would regard any such loan as chargeable under section 419. Deanby could not afford a tax charge in excess of that in respect of a £30,000 loan (and even that would involve calling in the loan to Glendinning McLeish). The Inspector (Mr Curry) and Mr McCaughey debated the applicability of section 419, but agreed to differ; and in order to bring matters to a head Mr McCaughey purchased 4008 Stranwood shares from Deanby for £30,000 and took a simultaneous loan of the same amount from Deanby (at 16%). The transactions were effected by an exchange of cheques which cleared through Deanby's account on 24 September 1997. The loan in that double transaction is the loan to which this appeal directly relates. The assessment in respect of it was issued on 25 June 1998, and it was duly appealed on 10 July 1998.

12. At the time when the 1997 loan was made, the accumulated balance in Deanby's profit and loss account was less than £12,000.

The parties are agreed that the questions to be answered are:

(i) does Deanby carry on a business which includes the lending of money? And if so,

(ii) was the 1997 loan made in the ordinary course of that business?

13. Deanby's case was presented by Mr McCaughey himself. His approach was quite simply as follows. Deanby is an investment company carrying on business as such (and has always been so treated by the Revenue). The capital investments have changed from time to time : initially they consisted substantially of properties for letting, then there was a period during which they were, for the most part, loans to himself, and more recently they have been other investments. If the loans (both the earlier ones which found their way into the partnership and the 1997 loan, not to mention the loan to Glendinning McLeish) were not investments within Deanby's ongoing investment business, what were they?

14. Mr McCaughey did not in any way rely on the fact that the Revenue had not raised the issue in the past in relation to any of the earlier loans.

15. In the view of Mr Curry, the Inspector who argued the case for the Revenue, the purpose of the exclusion from the charge "is to protect a company which carries on general money lending as part of its business and which makes a loan to a participator in line with the general principles and procedures it follows in making loans to borrowers who are not participators". He would not go so far as to say that the exclusion applied only to traders carrying on the business of a bank or registered moneylender, but the mere making of loans on commercial terms did not suffice. The company must show that it operates something recognisable as a general loan business in which any loan to a participator would be coincidental.

16. Mr Curry pointed out that Deanby has made only eight loans over the past 16 years and cited McCardie J in Edgelow v MacElwee [1917] 1 KB 205 at p.206:

"A man does not become a money-lender by reason of occasional loans to relations, friends, or acquaintances, whether interest be charged or not. Nor does a man become a money-lender merely because he may upon one or several isolated occasions lend money to a stranger. There must be more than occasional and disconnected loans. There must be a business of money lending, and the word `business' imports the notion of system, repetition and continuity."

Further, Mr Curry submitted that there was here no evidence of intention that any of the loans to Mr McCaughey were meant to be part of a series (c.f Stevenston Securities Ltd v CIR 38 TC 459).

17. But the case upon which Mr Curry relied most for guidance was Steen v Law [1963] AC 287 (P.C.). That case was concerned with the well-known statutory provision prohibiting the lending by a company of money to facilitate the purchase of its own shares: but it includes an exemption in terms substantially

identical with the exclusion-from-charge words in section 419. At pp.301, 302 Viscount Radcliffe, delivering the judgment of the Board said:

"This proviso, then, must be read ... as protecting a company engaged in moneylending as part of its ordinary business from an infraction of the law ... Even so, the qualification is imposed that, to escape liability, the loan transaction must be made in the ordinary course of its business. Nothing, therefore, is protected except what is consistent with the normal course of its business, and is lending of a kind which the company ordinarily practices.

In their Lordships' opinion, such an approach to the interpretation of proviso (a) necessarily requires that the "lending of money", to be part of the ordinary business of a company, must be what may be called a lending of money in general, in the sense, for example, that moneylending is part of the ordinary business of a registered moneylender or a bank."

The repeated references to moneylending, and in particular the reference at the end of that passage to "a lending of money in general" clearly encourage the approach to the words of exclusion in section 419 adopted by the Inspector. He accordingly submitted that Deanby's business did not include the lending of money, so answering the first question in the negative.

18. Furthermore, he submitted that since Deanby never made any ordinary loans (i.e., ones to outsiders, the loan to Glendinning McLeish not really qualifying as such) it was not possible to say that the 1997 loan was made on terms comparable with loans made in the ordinary course. The answer to the second question was accordingly also in the negative.

19. The first step, in my judgment, is to identify the type of business carried on. There is no question here but that we are dealing with an investment company. I was not referred to any authority on section 419, or on any other provision with the same or similar form of words in an excluding proviso, which had an investment company as its context.

20. The next question is, does the investment business of that company include the making of loans? Of course, I agree with the Inspector that an investment business does not necessarily involve the making of loans; but it may well do so in fact. To be part of the business, the loans must, in my opinion, be made as investments. I do not consider it appropriate, at least in this context, to look for a quasi-separate moneylending business (with sideways glances at the `badges of trade') because the company is, by definition, not trading. However, in that connection, I may observe that while the loans made by Deanby over the years were not numerous, their number exceeded, I believe, that of the properties acquired and held over a much longer period in the early years, and that of the shareholdings more recently - both of which appear to be accepted as investments.

21. I find as a fact that the loans made by Deanby prior to Mr McCaughey's retirement from the partnership were made as investments. True, there is a shortage of documentary evidence but Mr McCaughey's oral evidence, which I accept, showed that there was a deliberate change of investment policy; and that was amply supported by what actually happened thereafter, even as regards Deanby alone. But I would go further and say that Mr McCaughey was fully entitled to pray in aid, for evidentiary purposes, the lending activities of Barr and

Camden, bearing in mind the extremely intimate relationship between the three companies. I therefore conclude that the lending of money had become included in Deanby's business, and that the first question accordingly falls to be answered in the affirmative.

22. In saying that I feel obliged, in deference to Mr Curry's argument, to say something about Steen v Law beyond distinguishing it on the ground that investment companies were probably not in mind and that a different provision, with a different policy objective, was involved.

23. The passage from Lord Radcliffe's judgment which I have set out above is immediately followed by a sentence which indicates, in my view, what he meant by "a lending of money in general". He refers to lending where the money lent is at the borrower's free disposition. In short he is thinking of the character of the loan, and is not in any way seeking to define the class of qualifying lender or borrower. Later in the judgment he explains why the loans made prior to the impugned loan did not suffice to make the lending of money part of the company's business : they were neither on commercial terms nor at interest. (In particular, as respects the loans made to the company's subsidiaries, the borrowing requirements of the subsidiaries arose out of the artificial trading terms upon which their parent, the lender, required them to do business.) It was not the relationship between lender and borrower which was the problem : it was the fact that the loans were for a particular purpose, so that the money was not free in the hands of the subsidiaries, which made them not "general" loans.

24. Later in the same paragraph starting with the already cited passage comes this sentence:

"Thus a company which, for instance, lent money from time to time to trade suppliers or purchasers could claim that the lending of money was part of its ordinary business, and that it was accordingly one of the companies intended to be protected by proviso (a), if it chose to make loans in connection with the purchase of its shares."

This Lord Radcliffe thought absurd. However, it is clear that he is here addressing the second question (viz. that relating to the impugned loan itself); but he does not suggest that the type of earlier lending mentioned could not qualify for the purpose of satisfying the requirement in the first question. No mention of banks or registered moneylenders here, or of lending in the public domain.

25. I therefore turn now to the second question. Clearly the management of its investments is an essential part of an investment company's business; and if it considers that a loan would be a better investment than a particular asset currently in its portfolio, the switch will be made "in the ordinary course of its business". In my opinion that, quite simply, is how the 1997 loan should be viewed. To my mind, it does not matter who the purchaser of the unwanted asset

is, or to whom the loan is made. And, after all, section 419 envisages excluded loans being made to participators or their close relations.

26. That suffices to conclude this appeal in Deanby's favour. I will, however, end by saying something about section 419 in general. It is common ground that this is an anti-avoidance section and from internal evidence it is clear that it is designed to counteract the avoidance of advance corporation tax by making loans instead of declaring dividends within close companies. In general, therefore, such loans are treated as suspect and tax is payable as if they had been dividends unless or until their bona fides as loans is demonstrated by repayment. It is no part of the object of the section to treat a company's capital as distributable income. Yet that would be the

effect of upholding the assessment under appeal. Quite apart from the fact that the 1997 loan represented an investment switch on capital account, a dividend of its amount could not lawfully have been declared. Mr Curry, to his credit, appeared to be rather less happy with his argument when its effect was pointed out.

B M F O'BRIEN

SPECIAL COMMISSIONER

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