COSTS OF OBTAINING LOAN FINANCE – expenses of management of investment company – period for which the costs are disbursed - whether deductible when incurred or spread over the life of the loan in accordance with Financial Reporting Standard 4 – deductible when incurred

THE SPECIAL COMMISSIONERS SpC 00302

CADBURY SCHWEPPES PLC Appellant

- and -

A WILLIAMS

(HM INSPECTOR OF TAXES) Respondent

Special Commissioner: DR JOHN F AVERY JONES CBE

Sitting in public in London on Monday 19 November 2001

Julian Ghosh and Elizabeth Wilson instructed by Gordon Slater FCCA ATII of Cadbury Schweppes Plc for the Appellant

Christopher Tidmarsh instructed by the Solicitor of Inland Revenue for the Respondents

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DECISION

1. This is an appeal by Cadbury Schweppes PLC against an estimated assessment for the 1995 accounting period made on 27 October 1997. The Appellant was represented by Julian Ghosh and Elizabeth Wilson and the Inspector of Taxes by Christopher Tidmarsh.
2. The issue in the appeal is whether the Appellant, an investment company, can deduct the incidental costs of obtaining loan finance as an expense of management in the year when the expenses are incurred, as the Appellant contends, or spread over the life of the loan, as the Inspector contends, under the law as it was before the introduction of the loan relationships provisions.
3. The following facts were agreed:

1. The Appellant is a UK resident and incorporated company which operates as the holding company, directly and indirectly, for a number of trading companies operating in the UK and abroad. It is common ground that the Appellant is an investment company within the meaning of Section 130 ICTA 1988 for the accounting period ended 30 December 1995.
2. In the year to 30 December 1995, the Appellant issued three tranches of Eurobonds:

    a. $300 million 6.25% Notes due 1999 issued on 4 October 1995
    b. $200 million 5.875% Notes due 1998 issued on 1 December 1995
    c. £150 million 8% Notes due 2000 issued on 10 November 1995.

1. In that year, the Appellant also procured the issue by Cadbury Schweppes Delaware LP ("Delaware") of 16 million 8.625% Cumulative Guaranteed Quarterly Income Preferred Securities ("the Preferred Securities") on 11 April 1995 and the loan, by Delaware to the Appellant of the proceeds of issue. the Appellant owned the entire general partnership interest in Delaware.
2. In respect of these issues, the Appellant incurred various incidental expenses. The totals in respect of each issue were:

    a. In respect of the $300 million Notes, £3,217,750
    b. In respect of the $200 million Notes, £1,848,729
    c. In respect of the £150 million Notes, £2,878,581
    d. In respect of the Preferred Securities, £8,990,596;

giving costs totalling £16,935,656.

It is common ground that there are no material differences between the various expenses. This appeal does not concern the tax treatment of the premium on issue for the accounting period ended 30 December 1995.

1. The accountancy treatment of these incidental expenses is governed by Financial Reporting Standard 4 ("FRS 4"). The effect of FRS 4 is that:

    a. The issue costs of securities are written off over the term of the securities;
    b. If it becomes clear that an instrument is to be redeemed early, the writing off is accelerated;

c. If there is no definite term, the issue costs are not taken to the profit and loss account until actual redemption or cancellation.

1. The incidental costs are all "issue costs" within the meaning of FRS 4.
2. The following table shows how the debt and the finance costs would be shown in a company's Balance Sheet and Profit and Loss Account respectively, pursuant to FRS 4. It also sets out two examples of the treatment, in accordance with FRS 4, of convertible loans.

Balance b/fwd Cost of raising Balance c/fwd

finance – P&L charge

Yr 1

Finance raised 100

Cost of raising finance -10

Net finance raised 90 1 91

Yr 2 91 1 92

Yr 3 92 1 93

Yr 4 93 1 94

Yr 5 94 1 95

Yr 6 95 1 96

Yr 7 96 1 97

Yr 8 97 1 98

Yr 9 98 1 99

Yr 10 99 1 100

Example 1

In year 10 the loan of 100 is repaid.

Dr Convertible loan creditor 100

Cr Cash 100

Example 2

In year 5 the loan is converted to share capital

Dr Convertible loan creditor 95

Cr Share Capital 95

3. The costs of the Eurobonds and the Preferred Securities were written off in accordance with FRS 4. The costs consist of selling commission, managers costs, management and underwriting commissions, New York Stock Exchange Listing fee, Moody's credit rating fee, printing costs, Standard & Poors rating fee, legal fees in the UK and US, accounting fees, trustee fees and sundry fees, totalling £16,935,656 in the year ended 31 December 1995. The breakdown is not set out here but is available.
4. In its corporation tax computation the Appellant deducted as expenses of management the full incidental costs of issue in respect of the Eurobonds and the Preferred Securities.
5. The work to which the relevant costs related was completed by the time that the loan was obtained in 1995 and none of the costs was refundable if the any of the loans were repaid early.

1. Relief is given for expenses of management by section 75 of the Taxes Act 1988:

   "(1) In computing for the purposes of corporation tax the total profits for any accounting period of an investment company resident in the United Kingdom there shall be deducted any sums disbursed as expenses of management (including commissions) for that period, except any such expenses as are deductible in computing profits apart from this section."

2. The incidental cost of obtaining finance is a capital cost that would not in principle be deductible but under the law as it was in 1995 is made deductible either as a trading expense for a trading company or for an investment company as expenses of management by section 77 of the Taxes Act 1988:

   "(1)...in computing the profits to be charged under Case I or II of Schedule D there may be deducted the incidental costs of obtaining finance by means of a qualifying loan or the issue of qualifying loan stock or a qualifying security; and the incidental costs of obtaining finance by those means shall be treated for the purposes of section 75 as expenses of management.

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   (6) In this section 'the incidental costs of obtaining finance' means expenditure on fees, commissions, advertising, printing and other incidental matters (but not including stamp duty), being expenditure wholly and exclusively incurred for the purpose of obtaining the finance (whether or not it is in fact obtained), or of providing security for it or of repaying it."

3. It is common ground that the Appellant is an investment company, that the expenditure in question was incurred wholly and exclusively for the purpose of obtaining a qualifying loan. The expenditure was both incurred and paid in 1995. The dispute turns on the meaning of "disbursed as expenses of management for that period" in section 75.

   Contentions of the Appellant

4. Mr Ghosh, for the Appellant contends that the words of section 75 are words of ordinary English usage and must be given their ordinary meaning. Deductions for expenses of management of an investment company are mandatory and are given by statute without reference to accounting principles. The taxable profits of an investment company are based on chargeable gains and gross income subject to various statutory deductions such as those for management expenses, funding costs of borrowing and capital allowances. He contends that the costs of raising capital are allowable in the year in which they are disbursed, meaning paid. He points out that under section 8(3) of the Taxes Act 1988 "corporation tax for any financial year shall be charged on profits arising in that year." The reference to for in section 75 must be construed in the light of this provision with the result that for means in. The costs in question are not repayable and all relate to the year of payment. Section 75(3) deals with expenses of management (and charges on income) exceeding the profits of the period and provides that the excess is carried forward to the following accounting period and is treated "as if it had been disbursed as expenses of management for that accounting period." This suggests that the year of disbursement is the relevant consideration.
5. There is no reason to expect that investment companies should be taxed in the same way as trading companies, although he did not concede that for a trading company the incidental costs of obtaining finance should be spread in accordance with the accounting treatment. Trading companies are taxed on profits for which accounting profit is an important starting point. Expenses of a trading company may be allowed in advance of being paid when they are provided in the accounts in accordance with accountancy principles, as in Johnston v Britannia Airways [1994] STC 763, Herbert Smith v Honour [1999] STC 173 and Jenners Princes Street Edinburgh v IRC [1998] STC (SCD) 196. Expenses of management of an investment company depend on their being disbursed, meaning paid. A statutory recognition of the fact that investment companies may in some circumstances be treated better than trading companies in relation to management expenses is found in section 76(2) restricting relief for management expenses of an insurance company so as not to reduce the tax below what it would have been if the company had been taxed under Case I. Originally this provision applied to investment companies generally but in Simpson v Grange Trust Ltd 19 TC 231 the House of Lords held that it could not be applied to investment companies that could never be taxed under Case I. Subsequently in 1965 the statute restricted the rule specifically to insurance companies.
6. He draws attention to anomalies in the Inspector's interpretation in relation to the costs of obtaining convertible loans which do not arise on his interpretation. Section 77(3) provides that a loan which is not convertible for three years is treated as qualifying, that is to say it is treated in the same way as if it is not convertible. On the Inspector's interpretation, following conversion no further annual costs are allowed which results in a different treatment of the costs from the costs of a non-convertible loan. Secondly, under section 77(4) a loan that is convertible, but not converted, within the first three years becomes qualifying after the three years and so on the Inspector's interpretation relief can never be obtained for the first three years' costs. (The Inspector's interpretation is in fact different, see paragraph 14 below.)

Contentions of the Inspector

7. Mr Tidmarsh, for the Inspector, contends that for means what it says, which is not in. The Tribunal must as a question of fact in the light of all

the circumstances determine the period for which the expense relates so as to give effect to the commercial reality of the matter. Thus an investment company might pay in year 1 for goods or services to be delivered in year 2, in which case they would be deductible as expenses of management in year 2. Conversely if they related to year 1 but were paid in year 2 they would, following payment, be deductible in year 1. FRS 4 is a guide, but is not necessarily determinative of the question. Paragraph 94 of FRS 4 describes the commercial reality of issue costs as follows:

"In the case of most debt instruments, the issuer has the use of funds during the life of the instrument, and in return pays interest. The benefit obtained from the issue costs is reflected in the interest expense: indeed, issue costs are in some cases economically indistinguishable from a discount on issue. Issue costs are therefore appropriately accounted for as a adjustment to the amount of the liability, which effectively results in their being charged over the life of the instrument...."

8. The word for is also used in Schedule E, which in section 19 taxes emoluments for the chargeable period, meaning that they have to be related to a particular period. An example of relating a bonus back for several years can be seen in Heasman v Jordan 35 TC 518. The principle stated by the House of Lords in Bray v Best [1989] STC 159 at 167g was equally applicable here: "...the period to which any given payment is to be attributed is a question to be determined as one of fact in each case, depending upon all the circumstances, including its source and the intention of the payer so far as it can be gathered either from direct evidence or from the surrounding circumstances" (per Lord Oliver).
9. He points out that the Appellant spread the costs over the life of the loans in its accounts. Its intention in incurring the incidental costs was to secure the loan finance for the period of the relevant instrument. The incidental costs are an integral part of the funding and it is artificial and misleading to attribute them to the period in which the instrument was issued. They were no more attributable to that period than the funding itself. The true and fair view was that part of the costs is attributable to each year of the duration of the relevant funding.
10. He made the point that his contention results in similar treatment of trading companies, which will follow the accounting treatment in deducting the expenses of raising loan finance, and investment companies which attribute the costs to the period for which they are disbursed in accordance with section 75. Section 77 relates to both types of company but does not address the issue of timing.
11. On the question of convertible loans, Mr Tidmarsh replied that it is not surprising that on conversion no further costs are allowable as the costs of issuing shares are not allowable. The anomaly, if it is one, applies equally to a trading company and is caused by section 77. Where a convertible loan is treated as qualifying when it has not been converted during the first three years, the Inspector's view is that the costs spread over the first three years become allowable in the fourth year and are not lost. This applies equally to a trading company.
12. On the carry forward of excess expenses of management their treatment as disbursed for the succeeding accounting period is equally consistent with his interpretation of *for.*

Reasons for the decision

13. Section 77 gives relief for the incidental costs of obtaining loan finance but says nothing about the period. Section 75 requires expenses of management to be deducted in the period for which they are disbursed. The issue is therefore for what period were these incidental costs of obtaining finance disbursed. Mr Ghosh, for the Appellant, concentrates on the obtaining of the finance which occurs fully in 1995 so that the costs incurred and paid in that year cannot be repaid. Mr Tidmarsh, for the Inspector, concentrates on the benefit resulting from the costs of obtaining the finance, namely having the use the finance during the life of the instrument, which is the approach taken by FRS 4. In my view, in construing a relief for the costs of obtaining the finance, one should relate them to the period when the finance is obtained (or if the finance is not obtained, the period when the finance is endeavoured to be obtained), rather than the period for which the company has the use of the finance. Section 77 is concerned with obtaining the funds, not having the use of them, although of course one follows from the other. The purpose of FRS 4 is different from that of section 77, being concerned with the treatment of the loan as a whole rather than the obtaining of it as a separate matter, so that it equates the costs of obtaining the finance with interest (or a discount on issue, which is effectively the same). It is concerned with spreading all the expenses relating to the loan over the life of the loan which is clearly economically sensible, even though it seems strange to me that the nebulous asset of the benefit of the costs is netted off against the real liability resulting in less than the full amount of the liability being shown in the balance sheet until the last year. Tax law, on the other hand, in 1995 did not take a global view of the loan. The interest was at the time treated in one way on the basis of the amount paid in the year, and section 77 is a provision specifically dealing solely with incidental costs of obtaining the finance which is treated in another way. Accordingly, I consider that the period for which the costs of obtaining the finance in question was disbursed was the 1995 period when the finance was obtained, and the costs were incurred and paid.
14. I would, however, agree with Mr Tidmarsh that one is not concerned necessarily with the year of payment, so that a pre-payment of the costs of obtaining the finance in the year before the loan is obtained, and a payment of costs in the year following the obtaining of the finance would both result in relief for the period in which the finance is obtained. It seems to me that both of these cases give full effect to the use of the word for in section 75.
15. I do not derive any assistance from section 75(3) dealing with the carry forward of excess expenses of management. The carried forward amount will not have been disbursed for the later accounting period on either interpretation of for and so they need to be made deductible in the later period.
16. I do not gain much assistance from the anomalies relating to the costs of obtaining convertible loans but I think there is a slight indication in the convertible loan provisions that the draftsman of section 77 expected that the costs would be deductible in the year they are incurred. In relation to a convertible loan which is convertible during the first three years section 77(3) provides that it is not a qualifying loan but section 77(4) goes on to provide that if it is not converted within the three years the loan is treated as qualifying. Subsection (5) then provides that the incidental costs are treated as incurred immediately after the three year period. This seems to me to be a slight indication that the draftsman thought that they would all be allowable in that period.
17. I agree with Mr Tidmarsh that it is in principle undesirable that trading companies should be treated differently from investment companies in this

respect, because a trading company would have to spread the costs of obtaining finance in accordance with FRS 4 which, for the purposes of this appeal I shall assume is the case, although this was not conceded by Mr Ghosh; it is certainly the Revenue's view, see Tax Bulletin No.22. However, any difference is caused by accounting treatment having developed for trading companies. I understand that in 1980, when section 77 was introduced, trading companies would have written off the costs of obtaining finance in the year when they were incurred. There is no authority for investment companies being taxed on the basis of accounting treatment and so one should not be surprised about differences in treatment between investment and trading companies.

18. Accordingly I find that the period for which the costs of obtaining the finance was 1995 and allow the appeal in principle.

J F AVERY JONES

SPECIAL COMMISSIONER

SC3079/2000

Authorities referred to in skeletons and not referred to in the decision:

Hoescht Finance Ltd v Gumbrell [1983] STC 150

Law v Coburn [1972] 3 All ER 1115

Russell v Town and County Bank 2 TC 321

Gallagher v Jones [1993] STC 537

Texas Land and Mortgage Company v Holtham 3 TC 255

LG Berry v Attwool 41 TC 547