

RELEASE OF DEBT – Taxes Act 1988 s.94 – partnership liability to service company – effect of consent order

THE SPECIAL COMMISSIONERS

WILDIN & CO (A FIRM) Appellant

- and -

ALAN N JOWETT Respondent

Special Commissioner: DR JOHN F AVERY JONES CBE

Sitting in London on Monday 8 July 2002

Graham Wildin, one of the partners, for the Appellant

Alan Jowett, HM Inspector of Taxes, in person

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DECISION

1. This is an appeal against an amendment made on 23 November 2000 by the Respondent Inspector under section 28B(3) of the Taxes Management Act 1970 to the Appellant's Partnership Tax Return for the year 1998/99. The Appellant was represented by Mr Graham Wildin, one of the partners, and Mr Alan Jowett, the Inspector, appeared in person.
2. There was a very full agreed statement of facts as follows
 1. This is an appeal against an amendment made on 23 November 2000 by the Respondent Inspector under section 28B(3) Taxes Management Act 1970 to the Appellant's Partnership Tax Return for the year 1998/99.
 2. The Appellant is a firm of Chartered Accountants. The firm acts on this appeal through Mr Graham Michael Wildin who is a chartered accountant and the 'nominated partner'. At all times material to this appeal, Mr Wildin has been a partner in Wildin & Co. Wildin & Co was formed on 1 July 1984 from the sole trade of Mr G M Wildin. Wildin & Co originally had two partners, Mr Wildin and Mr Andrew Cook. From 1 July 1988 until 12 January 1990 a Mr Willetts was a partner in the practice. On 27 February 1995, Mr Cook left the practice. Mr Robert Lewis is the only other current partner in Wildin & Co having joined the practice on 5 October 1990 as a salaried partner.
 3. Wildin & Co Limited (company registration No 01653349) was incorporated on 22 July 1982 (the "Company"). The purpose of the Company was to take over the day to day administration and running of the practice of Wildin & Co with effect from 1 January 1983 (i.e. prior to the commencement of the Wildin & Co partnership). Mr Wildin and Mr Cook, at all material times to this appeal, were the directors and only shareholders in the Company.
 4. On 1 July 1984 the Wildin & Co partnership entered into a contract with the Company (the "Service Contract"). Clause 1 of the Service Contract

provided that the Company was to "supply all the services of employment of staff, and other necessary services of the accountancy practice [i.e. Wildin & Co] on the basis of direct cost plus ten percent charge". By clause 2, the Service Contract was to run without limit of time but could be terminated by mutual agreement, by either party giving three months written notice, or upon the "disolution" of either Wildin & Co or the Company. Clause 3 provided that if the agreement was terminated other than by mutual agreement then a sum equal to the previous three full years service charge became due and payable by the terminating party to the other party. In the event that the terminating party was the Company then the partners of Wildin & Co were entitled to "offsett" (sic) any sums due from them to the Company against the termination payment due from the Company. Clause 5 provided that sums due to Mr Wildin in respect of his directorship of the Company were to be dealt with by way of "offsett" against sums due to the Company from Wildin & Co.

5. On 1 July 1990, Mr Wildin entered into a "Service Contract" with the Company in respect of his duties as director of the Company ("the Director's Service Contract") for a fixed period of five years commencing 1 July 1990 and ending 30 June 1995. Under the terms of the Director's Service Contract Mr Wildin was, inter alia, to ensure that the Company complied with its obligations to supply services to Wildin & Co. Mr Wildin's hours were to be agreed between the parties but were not to exceed fifteen hours per week with a maximum of forty weeks per year. The Company agreed to pay Mr Wildin remuneration of £100,000 in total over the life of the contract by way of annual instalments in amounts to be agreed. Payment of the amounts due to Mr Wildin was agreed to be by way of "offsetting" the amounts due to Mr Wildin under the Director's Service Contract against the balance owing to the Company from Wildin & Co under the Service Contract (mirroring clause 5 of the Service Contract). Where the amount due to Mr Wildin exceeded the amounts owing to the Company, then the balance was to be credited to a loan account in the name of Mr Wildin and made available for drawing by him.
6. For each of the years ended 30 June 1983 to 30 June 1992 inclusive, Wildin & Co made a deduction in its profit and loss accounts in respect of the Company's service charges and any unpaid balance due to the Company was included within the liability to the Company on its balance sheets for each of those years. For the year ended 30 June 1993 a credit was made to the profit and loss account for the services in the sum of £117,409 and a sum of £128,532 was deducted in the tax computation as the service charges were in dispute.
7. On 30 September 1992 HM Customs & Excise presented a petition for the winding up of the Company on a claim for £96,133 of unpaid VAT. On 30 November 1992 the Company ceased trading. On 3 December 1992 a winding up order was made in the Newport County Court. At the date of cessation of business (30 November 1992) the amount owed by Wildin & Co to the Company was calculated by Wildin & Co to be £208,090. The Respondent accepts that this is the amount due from Wildin & Co as at that date in respect of the service charges of the Company.
8. Although the amount due from Wildin & Co to the Company as at 30 November 1992 was £208,090 Wildin & Co claimed, in accordance with the termination provisions of the Service Contract, a set off of three years worth of full service charges amounting to £128,532.20. Wildin & Co also claimed a set off in respect of £66,000 being the net unpaid balance of the amount due to Mr Wildin under the Director's Service Contract (£100,000 less £34,000 already 'paid'). Thus the net amount due to the Company on the cessation of business was calculated by Wildin & Co to be £208,090 – (£128,532.20 + £66,000) = £13,557.80. This amount was in due course

- paid by Wildin & Co to the Liquidator of the Company (the amount actually paid was £13,854.07 as interest was added to the net amount due).
9. The Liquidator of the Company did not accept that Wildin & Co could rely on the termination provisions of the Service Contract or the terms of the Director's Service Contract to make deductions from the amount otherwise accepted to be due to the Company. In 1994 the Liquidator commenced proceedings in the High Court against each of the then partners of Wildin & Co (Mr Wildin, Mr Cook and Mr Lewis) to recover the full amount of the debt due to the Company. The Liquidator also commenced proceedings under section 212 Insolvency Act 1986 against the then partners of Wildin & Co.
 10. The two sets of High Court proceedings were settled on 8 March 1998 by means of a single consent order. The order was signed by solicitors acting on behalf of the Company and Liquidator and by solicitors acting on behalf for the partners of Wildin & Co. Under the terms of the Consent Order, in full and final settlement of all claims, cross-claims and set-offs, Mr Wildin agreed to pay to the Liquidator (and the Company) the sum of £120,000 in specified instalments. Mr Wildin also agreed to pay to the Liquidator any sum (or aggregate sums) in excess of £5,000 proved by creditors (other than HM Customs & Excise) in the Liquidation of the Company. Mr Wildin was given the right to examine any creditor claims against the Company and to require the Liquidator to dispute such claims provided that Mr Wildin indemnified the Liquidator.
 11. On 31 January 2000 the 1998/99 Partnership Tax Return for Wildin & Co was submitted to the Respondent.
 12. On 25 April 2000 the Respondent wrote to Mr Wildin and, separately, to Mr Lewis saying that he intended to make enquiries into the 1998/99 Partnership Tax Return. The Respondent asked Mr Wildin for a computation detailing how the figure for sales had been determined and whether the figure for sales included an amount (then put at £88,090) representing the "reliefs" [release] under section 94 Income and Corporation Taxes Act 1988.
 13. Having received no reply, on 14 June 2000, the Respondent issued a notice under section 19A Taxes Management Act 1970 seeking, inter alia, the computation referred to in paragraph 12 above.
 14. The Respondent sent a further letter on 4 August 2000 threatening penalty action if Mr Wildin did not comply with the section 19A notice. Mr Wildin replied, in a letter of the same date, that no figure for the release had been included in the figure for sales in respect of the settlement of the actions brought by the Liquidator as "The debt was incurred by Wildin & Co and the settlement with the liquidator was with myself solely."
 15. On 5 September 2000, the Respondent sought agreement from Mr Wildin that the profits of Wildin & Co for the year ended 30 June 1998 should be increased by the sum of £88,090 representing the balance of the service charges owed by Wildin & Co to the Liquidator of the Company.
 16. On 5 October 2000 the Respondent gave notice under section 28B(5) Taxes Management Act 1970 that he had completed his enquiries into the 1998/99 Partnership Return concluding that the claim to Capital Allowances should be reduced. On 23 November 2000 the Respondent notified Mr Wildin that he had amended his partnership statement, inter alia, to reflect the receipt of £88,090 treated by the Respondent as a release under section 94 Income and Corporation Taxes Act 1988 and the reduction in Capital Allowances.
 17. It was subsequently agreed that Wildin & Co had paid £13,557 to the Liquidator of the Company prior to the making of the consent order (see paragraph 8 above) and the claim to Capital Allowances was accepted as originally made.

18. Accordingly, the question for determination is whether there has been a release within the meaning of section 94 Income and Corporation Taxes Act 1988 of £74,533 [$£208,090 - (£120,000 + £13,557)$] in respect of the debt due as at 30 November 1992 from Wildin & Co to the Company.

1. In short, the Appellant partnership owed £208,090 to the Company but claimed a set-off resulting in its owing only a balance of £13,557. The liquidator of the Company settled the actions claiming the full amount of £208,090 from the partnership by a consent order requiring payment of a further £120,000 by Mr Wildin which the Inspector accepts was a payment on behalf the partnership. Accordingly the Inspector says that the remaining liability of the partnership amounting to £208,090 - (£120,000 + £13,557) = £74,533 has been released and is taxable under section 94 of the Taxes Act 1988. Paragraph 17 of the statement of facts explains why the £13,557 was not originally, but is now, accepted.
2. Section 94 provides:

Where in computing for tax purposes the profits of a trade, profession or vocation, a deduction has been allowed for any debt incurred for the purposes of the trade, profession or vocation, then, if the whole or any part of the debt is thereafter released otherwise than as part of a relevant arrangement or compromise, the amount released shall be treated as a receipt of the trade, profession or vocation arising in the period in which the release is effected.

It is common ground that, if there is a release, it is not part of a relevant arrangement or compromise, as defined in section 94(2). It is also common ground that the full £208,090 has been deducted in the computation of the partnership profits. The question is whether any amount, and if so what amount, has been released.

3. The dispute essentially turns on the effect of a further provision of the consent order contained in paragraph 3 of the Schedule which is as follows:

Mr Wildin will pay to the Plaintiff [the liquidator] the sum or sums equivalent to the aggregate of any sums proved by creditor(s) in the liquidation of Wildin & Co Limited ("the Company") – other than the Commissioners of Customs and Excise – to the extent that the aggregate of such sums exceeds £5,000, such payment(s) to be made in equal monthly instalments from the date of acceptance of proof of such creditors to 1 March 2002.

4. Mr Wildin produced a letter from the liquidator's solicitors stating that the liability under paragraph 3 is £43,574.47. He contends that this sum should be deducted from the amount released of £74,533. Alternatively, he claims that there has been no release of the partnership liability but an assignment of the burden of the liability to him.
5. There two possible interpretations of paragraph 3. The first, put forward by Mr Wildin, is that the liquidator wanted to pay Customs and Excise as nearly as possible in full and so he accepted £120,000 on the basis of the known creditors, which would result in Customs being paid all but £4,477 of their liability of £122,751 according to the Official Receiver's report dated 1 February 1993 (although this is presumably before the expenses of liquidation). On that basis paragraph 3 is still concerned with the partnership's liability and is there to deal with the possibility of further

creditors coming forward so that the result for Customs and Excise will be unaffected. The alternative interpretation put forward by Mr Jowett is that the liquidator was settling a claim against Mr Wildin as a director under section 212 of the Insolvency Act 1986 relating to director's liability for misfeasance or breach of any fiduciary or other duty. On that basis, paragraph 3 is unrelated to the partnership debt and any payment under that paragraph does not reduce the amount released.

6. In favour of Mr Wildin's interpretation is a letter dated 3 March 1998 from the liquidator's solicitors to Customs and Excise in which they say:

Mr Wildin was firmly of the view that all creditors of the company with the exception of Customs and Excise had been paid... and Mr Wildin stressed this aspect of the company's financial position to argue that the actual dividend receivable by Customs and Excise would be better than it appeared on the basis of the original Statement of Affairs sworn by the director.

Our response was to indicate that if we were to recommend Mr Wildin's offer to Customs and Excise on the faith of the representations which he was making, we expected him to back his representations with persuasive assurances as to their truth. In the circumstances, therefore, we persuaded Mr Wildin to agree that, to the extent that additional creditors of the company exceeded £5,000, he should pay an equivalent sum to the liquidator in addition to the sum of £120,000. By this means we are hoping that we will have protected your prospective dividend.

7. Mr Jowett's interpretation of paragraph 3 is that it deals with the Company's creditors which has nothing to do with the partnership which has settled its liability at £120,000, so that paragraph 3 must relate to something else, presumably Mr Wildin's liability as a director under the Insolvency Act. Mr Jowett pointed out that Mr Wildin's liability under that paragraph is not limited to the amount owing by the partnership to the Company before any set-off which makes it unlikely that it relates to the partnership's liability.
8. I asked if, following the hearing, Mr Wildin could send me the statement of claim by the liquidator as it might throw some light on this question. He sent in a copy of the Application in one of the two actions together with the Liquidator's affidavit. In this action the Liquidator claims a Declaration that Mr Wildin and Mr Cook in their capacity as directors and Mr Lewis as a person who took part in the management of the Company were guilty of misfeasance or breach of trust or fiduciary duty in entering into the agreement with the partnership and the service agreement with Mr Wildin (and other matters); an Order that accounts be taken of the breaches of duty and an Order that the three compensate the Company for their breaches of duty; a Declaration that the set-off is a preference and is voidable; an Order that the three pay £208,090 to the Company. Mr Jowett through the Inland Revenue's Solicitor's Office obtained a copy of the writ in the other action which is a claim by the Company (in liquidation) against the partners for breach of contract for £208,090.
9. As I read the situation, the liquidator was trying to recover as much for Customs and Excise, the largest creditor, as he could and was really trying to avoid any set-off reducing the partnership's agreed debt of £208,090. I do not think that the liquidator was trying to obtain payment of the amount of the creditors from Mr Wildin (or the other two) as a director as a separate matter. The claim against the directors is for breach of duty in relation to the agreement which gave rise to the set-off, not a separate

action relating to breach of duty generally. This interpretation is supported by the letter from the liquidator's solicitors quoted above that the liquidator would only settle the action if Customs' position was unaffected by the discovery of other creditors. In short, the actions were about recovering the £208,090 without set-off, or sufficient of that amount as would enable Customs and any additional creditors who might appear to be paid in full or nearly so.

10. It is certainly odd, if this were the case, that Mr Wildin and his advisers did not limit the liability under paragraph 3 to the total liability of the partnership to the Company. However, presumably Mr Wildin had a good idea of the likely total amount of creditors of the Company and knew that they could not possibly result in his having to pay more than the £208,090; in the first paragraph quoted above from the letter from the liquidator's solicitors he is quoted as saying that there were no other creditors. I also suspect that the consent order was drafted at the door of the court and in such circumstances orders do not always contain all the safeguards one might expect.
11. My conclusion is therefore that the net result of both actions was to recover so much of the partnership's agreed liability without set-off as would result in the creditors being paid in full or nearly so. Paragraph 3 is the mechanism for protecting Customs and Excise's position if more creditors came forward after the consent order was entered into. Accordingly any further payment under paragraph 3 reduces the amount otherwise released.
12. Mr Jowett raised a further point that if payments under paragraph 3 reduced the amount released they would have to be allowed in later years. I do not think that is right. Paragraph 3 provides a formula for calculating the amount released. The result may be that the assessment for that year cannot be finalised until the paragraph 3 amount is determined, but it cannot be that one treats the maximum amount as having been released in 1998/99 and part of that sum to be un-released in a later year when further creditors come forward and are paid.
13. Mr Wildin's also contends that there had been what he calls an "assignment" of the liability to him. There is no evidence of this. The consent order ends the action by the liquidator against the partners, and the counterclaim by the partners against the Company. The order is in full and final settlement of all claims, cross-claims and set-offs arising out of the two actions both of which are actions by the Company, or the liquidator, against all the partners. If the liability were to be transferred to Mr Wildin alone there would have to be a novation with the liquidator releasing the other partners. This is most unlikely since this is a contract debt the partners are liable jointly (section 9 of the Partnership Act 1890) so the liquidator can collect the whole from Mr Wildin, which is what he did, and Mr Wildin has a right of contribution from the other partners which he may or may not wish to exercise. There would be no reason for the liquidator to change this position. I am also unclear how the point helps the Appellant because if there had been a novation the release of the partnership's debt would have been greater. I find that there was no such novation of the partnership's liability and Mr Wildin merely paid part of the partnership's liability because he was jointly liable to pay it as one of the partners.
14. Accordingly I find that there has been a release of part of the partnership's liability amounting to at least £74,533 but that this amount should be reduced by the amount of the additional payment equal to the further payments made under paragraph 3 of the Schedule to the consent order. I assume that the Inspector has not had the opportunity of verifying the figure of £43,574.47 as the amount of the additional creditors of the

Company. Accordingly I shall not determine the appeal in figures at this stage but merely say that in principle the appeal is allowed to the extent of reducing the amount released (£74,533) by £43,574.47 or whatever amount is determined to be the final amount of the additional creditors for which Mr Wildin is liable under paragraph 3 of the Schedule to the consent order.

DR JOHN F. AVERY JONES

SPECIAL COMMISSIONER

Authorities referred to in argument and not referred to in the decision

Hall v IRC 11 TC 24

Linden Gardens Trust Ltd v Lenestra Sludge Disposals Ltd [1994] 1 AC 85

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