

Chapter 8

Taxation of Shareholders, Creditors, Guarantors etc.

GENERAL

8.1 This chapter is intended as a general guide to the UK tax position of shareholders, creditors, guarantors, landlords and various others who may find themselves losing money to, or discharging liabilities of, an insolvent company which is a UK resident limited company with a share capital. It is not intended as a comprehensive guide to the capital gains/loss regime, nor to the taxation of 'loan relationships', but focuses on those elements of the UK tax system which are most likely to have to be considered by persons in these categories in the context of an insolvent company. Certain aspects which arise in debt restructuring are dealt with in more detail in Chapter 12 and not in this chapter.

SHAREHOLDERS

Relief for capital losses of shareholders against tax on capital gains

8.2 The commencement of the formal insolvency of a company does not give rise to disposals by its shareholders (be they corporate or individual) of their shares. In a solvent liquidation, shareholders would be treated as making a disposal or part disposal of their shares when they received a distribution in the course of the liquidation (see *IR Man (CG)*, para 40431). In an insolvency this will not happen, but there will be a disposal of the shares when the company is finally dissolved. This would be a deemed disposal of the shares under *TCGA 1992, s 24(1)*, which provides that the occasion of the entire loss, destruction, dissipation or extinction of an asset shall constitute a disposal of the asset whether or not any capital sum is received. In practice, however, where shares have become worth little or nothing because of the appointment of a liquidator, administrator or receiver over the assets of the company concerned, an allowable loss will normally be claimed before dissolution under *TCGA 1992, s 24(2)* on the basis that the value of the shares has become negligible. For the loss to be allowable, a claim must be made to the Inspector of Taxes specifying the amount of the loss whereupon *TCGA 1992* has effect as if the claimant had sold, and immediately reacquired, the shares for a consideration of an amount equal to the value specified in the claim. [*TCGA 1992, s 24(2)(a)*]. Strictly, the notional disposal is to be treated as occurring when the claim is made (*Williams v Bullivant Ch D 1982, 56 TC 159* and *Larner v Warrington Ch D, [1985] STC 442*). Under *TCGA 1992, s 24(2)(b)*, however, the claim may be made in respect

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of an 'earlier time' falling not more than two years before the beginning of the year of assessment (or in the case of a company on or after the first day of the earliest accounting period ending not more than two years before the time of the claim). It is also a condition that the taxpayer must have owned the asset at the 'earlier time' and that the asset 'had become' of negligible value at the 'earlier time' [*TCGA 1992, s 24(2)(b)(i) and (ii)*]; however, with effect from 6 April 2009, a claim may be made for a negligible value if the asset was acquired on a no-gain/no loss disposal at a time when it was already worthless. [*Enactment of Extra-Statutory Concessions Order 2009, SI 2009 No 730*]. The words 'had become' were considered by the Special Commissioners in *Marks v McNally*, [2004] *STC (SCD) 503* where it was held that, apart from his failing to make a proper claim in his return, the taxpayer could not claim relief as the shares were already worthless when he obtained them (and the ESC, enacted in 2009, was unavailable).

8.3 The computation of the loss on the notional disposal is made on the basis of the legislation in force at the date of the claim, not that of the notional disposal. Although, in many cases, the shareholder and the company will be connected, there is no acquisition of an asset on the disposal by the shareholder in the liquidation, or on the making of a negligible value claim, so the restriction on the use of losses in *TCGA 1992, s 18(3)* does not apply.

8.4 The relief under *TCGA 1992, s 24* may be given against capital gains of the same accounting period or year of assessment. Alternatively, under *TCGA 1992, s 8(1)(b)* (in the case of a company), or *TCGA 1992, s 2(2)(b)* (in the case of an individual), losses unutilised in the same accounting period or year of assessment may be carried forward to subsequent such periods. For companies, this is subject to the restrictions on relief for certain 'pre-entry' losses on joining a tax group, or for offset against certain pre-entry gains in companies joining a tax group, under *TCGA 1992, Schs 7A and 7AA*.

Restoration of company to the Register

8.5 As described in **1.43–1.46** above, the situation sometimes arises that a company which has been dissolved is restored to the register by an order of the court under what is now *CA 2006, s 1031*. Under the new power in *CA 2006, s 1027*, this may also be effected administratively. This can be for various reasons—the most likely being to recover assets or pursue claims ignored or unrecognised at the time the company was dissolved. This is not a situation specifically contemplated by *TCGA 1992*. The author's view is that the shares are to be considered as the same assets as the old ones: the express effect of these provisions is that 'the company is deemed to have continued in existence as if it had not been dissolved or struck off the register'. [*CA 2006, ss 1028(1) and 1033(1)*]. Shareholders should therefore enjoy the same base cost in the shares for the purposes of taxation of capital gains as they originally enjoyed. If a 'negligible value' claim has been made under *TCGA 1992, s 24(1)*, the base cost will be nil (or such other value as was specified in the claim under *TCGA 1992, s 24(2)*).

Substantial shareholdings

8.6 A shareholder which is a company may be exempt from tax on capital gains on a disposal of a holding of shares if the shareholding is 'substantial' and if certain conditions are satisfied both by the shareholder and the investee company, as set out in *TCGA 1992, Sch 7AC*. Where the investee is insolvent, this will normally mean that the shareholder will be denied relief for a loss rather than benefiting from a relief. For reasons of space, it is not possible to set out all the conditions for this treatment to apply but some salient points in an insolvency, in addition to those discussed from a liquidator or administrator's viewpoint in **5.49–5.51** above, are as follows (references to paragraphs in this paragraph are to *Schedule 7AC* unless otherwise stated):

- (a) The shareholding must amount to not less than 10 per cent of the company's ordinary share capital. The usual tests of profits on a distribution in *ICTA 1988, Sch 18* also apply. [*Paragraph 7*]. For this purpose, group holdings are aggregated. [*Paragraphs 2(3) and 9*]. In the rare cases that shares are vested in a liquidator under *IA 1986, s 145*, they also count as held by the company concerned [*paragraphs 2(4) and 16*], though as noted in **5.49–5.51** above, this does not necessarily mean that exemption is applicable in a liquidation of the investor company. This condition must have been satisfied throughout a 12-month period beginning not more than two years before the date of the disposal. [*Paragraph 7*].
- (b) A disposal for this purpose includes a notional disposal under *TCGA 1992, s 24*.
- (c) The investing company must be a sole trading company or *member* of a 'qualifying group'. This means a trading group, disregarding activities carried on otherwise than for profit by a company not established for profit. [*Paragraph 18*].
- (d) The investee company must also be a trading company or the *holding company* of a trading group or a trading sub-group. This condition must be met throughout the period beginning with the start of the 12-month qualifying condition for the shareholder under *paragraph 7* (see (a) above) and ending with the time of the disposal, and it must also be a trading company immediately after the disposal. [*Paragraph 19*].
- (e) As will be appreciated, in a situation where the investee company is insolvent, the trading condition will be critical. A trading company is defined as 'a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities'. [*Paragraph 20(1)*]. Trading activities are also defined and include activities carried on by the company 'in the course of, or for the purposes of, a trade carried on by it' and certain preparatory activities or ones carried on with a view to acquisitions normally irrelevant in an insolvency. [*Paragraph 20(2)*]. The disregard of non-trading activities does not extend to those carried on in the course of winding up a company's activities although the statement in *IR Man (CG)*, para 53116d that a company's history can be looked at over a longer

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timescale indicates that there may be some flexibility as the company's overall activity over a period of time can be considered. Otherwise, a company in liquidation or whose assets consist of cash on deposit from disposal of fixed charge assets by a receiver may not satisfy this requirement. It is not clear to what extent the activities of an administrator or receiver as agent of the company would be counted to deny relief in applying the 'substantial extent' test.

- (f) There is, however, a 'subsidiary exemption' which may also apply where a company disposes of a substantial shareholding and the conditions for the exemption were satisfied at some time within the period of two years ending with the disposal, and certain conditions are satisfied. See further 5.51 above.

Some specific issues with this exemption are discussed in the context of restructuring in 12.91 below.

Relief for capital losses of shareholders against income

'Share loss' relief

8.7 Apart from relief against other capital losses, where certain conditions are satisfied a shareholder (corporate or individual) may be eligible to set off a loss realised on the disposal of 'qualifying shares' against income, under *ITA 2007, Pt 4 Ch 6* (formerly *ICTA 1988, ss 573–576*). This includes a loss on a notional disposal under *TCGA 1992, s 24(2)* as well as any other loss on a distribution in the liquidation, administration or striking-off or dissolution of a company. [*ITA 2007, s 131(3)*]. The conditions are very detailed and quite narrow. Shares may be 'qualifying shares' if either the Enterprise Investment Scheme (EIS) relief is attributable to them, or they are shares in a 'qualifying trading company' which were subscribed for in consideration of money or money's worth by the individual or a spouse or civil partner to whom the shares were transferred during their lifetimes or received as a bonus issue in respect of such shares. [*ITA 2007, ss 131, 135*]. To be a qualifying trading company, a hierarchy of tests must be met including a 'trading requirement' to the effect that, put oversimplistically, the company or its group must exist wholly for the purpose of carrying on one or more qualifying trades. [*ITA 2007, s 137*]. In applying this test there is a specific provision that a company does not fail the trading requirement 'merely because of anything done in consequence of the company or any of its subsidiaries being in administration or receivership' (subject to an anti-avoidance test). [*ITA 2007, s 138(1), (2)*]. There is also a specific provision that the dissolution or winding up of a company does cause the company to fail the test unless it is for genuine commercial purposes and the company continues to be a trading company (see further 5.8–5.13 above). The details of this relief are outside the scope of this book.

Corporate venturing scheme

8.8 *FA 2000, s 63* and *Sch 15* introduced the corporate venturing scheme, under which companies (other than financial traders or members of a financial

trading group) investing in ordinary share capital in a qualifying venture company between 1 April 2000 and 31 March 2010 could obtain relief both for their investment in the shares and for any allowable loss on their disposal. Very similar conditions apply in relation to insolvency as for 'share loss' relief—see *FA 2000, Sch 15 para 24*.

Dealers in shares

8.9 A loss incurred in the course of a trade by a shareholder which is a dealer in shares and holds the shares as trading stock is not affected by the rules restricting bad debt relief for loans made by traders and others, described below. The loss on shares whose value is written down or which are sold at a loss will normally be given according to the dealer's usual accounting treatment as a trading expense or loss.

Base cost for capital gains purposes

8.10 The base cost of shares for capital gains purposes will generally be the amount paid or subscribed for them plus other items of eligible expenditure. It should, however, be noted that *TCGA 1992, s 17(1)* requires the substitution of market value for the price paid in certain circumstances, in particular, where the shares were acquired otherwise than by way of a bargain made at arm's length or for a consideration that cannot be valued. This provision would apply automatically where the person acquiring the shares is connected with the company as this would be deemed to be an acquisition otherwise than at arm's length under *TCGA 1992, s 18(2)*. *TCGA 1992, s 17(1)* does not apply to the acquisition of an asset if there is no corresponding disposal of it (as it is considered there would not be on a subscription for shares, see *Harrison v Nairn Williamson Ltd CA 1977, 51 TC 135*) and where there is no consideration in money or money's worth for the acquisition, or the consideration is of an amount or value lower than the market value of the asset. [*TCGA 1992, s 17(2)*]. Thus, if on a non-arm's length transaction shares are worth less or more than the amount subscribed for them, it is the lesser amount which is taken as the base cost for the purposes of taxation of capital gains. There is a provision of similar effect to those just noted in relation to company reorganisations in the second part of *TCGA 1992, s 128(2)*. A tax avoidance scheme to transform a non-allowable capital loss was rejected in *CIR v Burmah Oil Co Ltd HL 1981, 54 TC 200*, and that case and the more recent judgments following *WT Ramsay Ltd v CIR HL 1981, 54 TC 101* must be considered in this context, so that where the 'Ramsay principle' applies the base cost may be affected.

Distributions to shareholders

8.11 Distributions to members of a company in their capacity as shareholder are by definition most unlikely to arise in an insolvent liquidation or administration but the subject cannot be ignored, if only because similar rules apply on distributions, in the course of a liquidation administration or

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CVA, to holders of other types of security which are subject to CGT or corporation tax on chargeable gains (but not those taxed as ‘loan relationships’). It is expressly provided that distributions made in respect of share capital in a winding up will not be treated as income distributions for tax purposes. [ICTA 1988, s 209(1)]. This includes distributable reserves arising from prior years’ profits (see *CIR v Burrell CA 1924, 9 TC 27*, a profits tax case) and arrears of dividends payable in respect of preference shares—see *Re Dominion Tar and Chemical Co Ltd, [1929] 2 Ch 387* which concerned the old income tax deduction rules. The exception which this proviso affords (i.e. that amounts which would otherwise be distributions of income may be treated as capital distributions) also applies as a concession (ESC C16) where a company is dissolved under CA 2006, Pt 31 by being removed from the register without a formal liquidation, and assets are transferred to its members after creditors have been paid off. This concession, which is to be legislated in the near future (and its limitations) is discussed (with its limitations) in 9.14–9.21 below. HMRC accept that the proviso to ICTA 1988, s 209(1) can apply to winding-up procedures under the laws of non-UK countries (see IR Man (CT), para 36130).

8.12 Distributions in respect of shares made in a liquidation are generally treated as capital distributions under TCGA 1992, s 122(1). Where several distributions are made in different years, each amount distributed may be deducted from the base cost of the shares where it is small as compared with the value of the shares. [TCGA 1992, s 122(2)]. For this purpose, ‘small’ normally means 5 per cent or less, but a receipt is also treated as small whenever its value is £3,000 or less whether or not it also meets the 5 per cent test—see Revenue Interpretation 164. Where the amount of the distribution exceeds this, the shareholder will be treated as having made a part disposal of his shares and the normal rules of computation for part disposals contained in TCGA 1992, s 42 will apply. To avoid the necessity of valuing the shareholder’s residual rights in the shares, it is open to a shareholder of a company which is not a quoted company to adopt the simplified procedure set out in SP D3.

8.13 Where a distribution is made of an asset, rather than cash (i.e. a distribution *in specie*), there will be two disposals to be taken into account. First, the company may be subject to tax on chargeable gains in respect of its disposal of the asset, which will be deemed for this purpose to take place at market value. [TCGA 1992, s 17(1)]. Secondly, the shareholder will be deemed to acquire the asset at the same value, which will be taken into account for the purposes of computing his own gain on the disposal or part disposal of his share. See IR Man (CG), para 40431. For transfers between a group of companies, however, the position is different. In *Innocent v Whaddon Estates Ltd Ch D 1981, 55 TC 476* the application of TCGA 1992, s 171 (as it now is) to a distribution *in specie* by a 75 per cent subsidiary in liquidation to its parent was considered. The judge held that the first disposal (that by the subsidiary) should be ignored; but that by virtue of the proviso to TCGA 1992, s 171(2), which disapplies the exemption in TCGA 1992, s 171(1) from capital distributions within TCGA 1992, s 122, the second disposal (of the shares in the subsidiary by the parent when the distribution is made) could not be ignored. This was consistent with the Revenue practice confirmed, after the facts giving

rise to the case but before the decision, to the ICAEW in 1975 (CCAB TR 172 June 1975). See now IR Man (CG), para 40460.

8.14 It should be noted that the definition of 'group' for the purposes of chargeable gains was amended by *FA 2000, Sch 29 para 1* in relation to disposals on or after 1 April 2000. A group can now comprise both UK resident and non-resident companies, so that, provided the asset concerned remains within the charge to corporation tax, transfers can be made at no gain, no loss under *TCGA 1992, s 171*. Thus, for example, on the distribution *in specie* to a UK parent company of an asset used for the purposes of a UK trade carried on through a branch of a non-resident subsidiary in liquidation, the principles in *Innocent v Whaddon Estates Ltd* will apply. Similar issues require to be considered in relation to group reconstructions, for example, those within *TCGA 1992, s 139*.

8.15 Until enactment of *FA 2009*, where the shareholder receiving distributions on liquidation was a member of a group of companies, it could not jointly elect with another group member under *TCGA 1992, s 171A* for the disposal to be deemed to have been made by that other company. This was because on the disposal of shares in a company in liquidation on its dissolution or on a negligible value claim (or, unlikely in an insolvency, in the course of a part disposal on a distribution) there is no corresponding acquisition, so the requirement that they are disposed of to a person outside the group was not met. This lacuna has now been rectified in respect of chargeable gains and allowable losses accruing on or after 31 July 2009 (that is to say, in this case, disposals and part disposals on or after that date). The new provisions introduced by *FA 2009, Sch 12*, allowing the reallocation of gains or losses within a group generally apply where a chargeable gain or loss accrues to a company in respect of an asset and do not require a deemed transfer of the asset between them. If the company accruing the gain or loss (called 'company A') is a member of a group with another company, 'company B', and if on a disposal of the asset from company A to company B group relief would have applied under *section 171(I)*, a joint election can be made by the two companies to transfer the gain or loss or part of it from company A to company B. [*TCGA 1992, s 171A*]. The gain or loss is then treated as accruing to company B at the same time as it would have accrued to company A but for the election. [*TCGA 1992, s 171B(4)*]. A payment between the companies in pursuance of an agreement in connection with the election which does not exceed the amount of the gain or loss is not taken into account for tax purposes. [*TCGA 1992, s 171B(6)*].

CREDITORS

Summary of the reliefs available

8.16 The tax treatment of creditors of insolvent companies was somewhat complicated by the regime for taxation of debts introduced by *FA 1996, Pt IV Ch 2*. Prior to introduction of this legislation the rules for companies and individuals, trustees, etc. were much the same. Now, the regimes are almost completely different. This is reflected in the rewrite of the tax legislation which

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has further separated the corporation tax rules from the income tax rules but there is, of course, overlap and possible confusion when it comes to the legislation on capital gains, which has not been rewritten, and applies to both (but differently).

Reliefs for losses for creditors which are individuals, etc.—summary

8.17 For individuals, trustees and others subject to income tax or CGT rather than corporation tax, the position is as follows:

- (a) As interest on savings income is only taxed on receipt (see **8.22** below), no special relief is needed for interest which has accrued but is unpaid.
- (b) Relief is generally only available for a loss of principal against income if the creditor concerned became a creditor in the course of a trade. In this case, a loss may be eligible for relief against trading profits for a bad or doubtful debt. See **8.29–8.37** below. This is subject to the limitations discussed in **8.38** below.
- (c) No relief against income is generally available for losses of principal in respect of securities, even if they are ‘deeply discounted securities’ within *ITTOIA 2005, ss 427–429* or interests in non-qualifying offshore funds within *ICTA 1988, s 757*, where any gain is taxable as income. An exception is for deeply discounted securities held continuously since before 27 March 2003 and listed on a recognised stock exchange at some time before that date.
- (d) If the loss arises in respect of the principal amount of a loan or security held as a capital asset, relief for a capital loss may be available. The rules determining when and how the loss arises depend on the CGT rules set out in **8.2–8.4** above and depend on making a claim that the asset is of negligible value, etc. or on a distribution to creditors. Alternatively, a loan may be disposed of actively by sale or by waiver of the debt. As with a share, the dissolution of the company will also be a disposal of the asset under *TCGA 1992, s 24 (l)*.
- (e) The potential relief for capital losses is, however, circumscribed by two exclusions which in practice mean that relief is unavailable in most cases. These are:
 - (i) If the creditor is the original creditor (that is, he has not assigned his debt), the loss will not give rise to a chargeable loss unless the debt is a ‘debt on a security’. [*TCGA 1992, s 251*]. See further **8.23–8.26** below.
 - (ii) Even if the debt is a ‘debt on a security’ or held by a person other than the original creditor, relief will not be available if the loan is a ‘qualifying corporate bond’ as defined in *TCGA 1992, s 117*. This applies to most sterling denominated securities. See **8.27** below.

In certain limited circumstances, as an exception to the rule described in (e)(i) above, even if the loan is not a ‘debt on a security’, relief as a capital loss is

available for ‘loans to traders’ as set out in *TCGA 1992, s 253*. See **8.28** below. Bad debts will also normally be deductible in computing the taxable profits of a property business. See **8.49–8.50** below.

Reliefs for losses for creditors which are companies—summary

8.18 Virtually all loan assets owned by a company which is within the charge to corporation tax (other than one carrying on a business which is specially treated, notably life insurance) will now fall within the regime for ‘loan relationships’ in *CTA 2009, Pt 5*. This brings gains and losses into charge as income (not capital), as trading or non-trading credits or debits depending on the basis on which the creditor is taxed. There is no distinction in most cases between interest (or other amounts receivable) and principal. In the legislation as originally drafted it was of great importance to determine whether the debt in question was a ‘money debt’ and ‘arose from a transaction for the lending of money’. [*CTA 2009, s 302*]. Certain types of debt, most notably trading receipts, were outside the regime because they did not ‘arise from a transaction for the lending of money’. Following successive changes made to the regime, this distinction is of much less importance. This is because *CTA 2009, Pt 6 Ch 2* ensures that the ‘loan relationships’ regime applies to ‘relevant non-lending relationships’ which are defined to include money debts ‘in relation to which an impairment loss ... arises to the company in respect of an unpaid ... business payment’. [*CTA 2009, s 479(2)(c)*]. ‘Business payment’ means ‘a payment which, if it were paid, would fall to be brought into account for corporation tax purposes as a receipt of a trade, UK property business or overseas property business carried on by the company’. [*CTA 2009, s 479(3)*]. Thus, the position of relief for losses by creditors in relation to trade receivables is now covered under the loan relationships rules. These are discussed in **8.41** and following below and in Chapter 12. Loan relationships are automatically ‘qualifying corporate bonds’ and thus outside the charge on chargeable gains. [*TCGA 1992, s 117(A1)*].

8.19 Notwithstanding the position just described, there are still some classes of debts owned as assets by companies which are outside the ‘loan relationships’ regime. The most obvious is income from a property business under the provisions mentioned in **8.49–8.50** below but these are in many cases now treated as loan relationships. Another example used in previous editions of this book was a debt arising on capital account but not from a transaction for the lending of money, such as deferred consideration for disposal of a capital asset falling to be treated as a separate chargeable asset subject to the principle in *Marren v Ingles HL, [1980] STC 500*. Even this asset may be a ‘relevant non-lending relationship’ now if interest is payable on it or if *CTA 2009, s 480* applies because a ‘discount arises’ from it. This will be the case if:

‘... the amount or value of the whole consideration exceeds what the purchaser would have paid for the property if payment in full had been required at the time of the sale and some or all of the excess can reasonably

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be regarded as representing a return on an investment of money at interest (and so being a discount arising from the money debt).’ [CTA 2009, s 480(5)].

A third example will be barter arrangements made in the course of a trade giving rise to impairment losses. The rule regarding impairment losses for non-money debts in CTA 2009, s 55 is discussed with the income tax rule (ITTOIA 2005, s 35) in 8.29–8.37 below.

8.20 The boundaries between loan relationships and other types of interest in an indebted company are discussed further in 12.5–12.6 below.

8.21 FA 2002 also introduced rules relating to derivative contracts now contained in CTA 2009, Pt 7, which, so far as bad debts are concerned, largely parallel the regime for loan relationships. The derivative contracts provisions are not considered separately in this chapter (but see 12.14–12.15 below in the context of rescues).

Relief for losses of creditors which are individuals, etc.

Unpaid interest

8.22 Income tax does not apply to interest (received on savings income and not in the course of a trade) which is unpaid even if the liability to pay it has accrued and even if it has fallen due. This follows from the decision in *Dewar v CIR CA (1935), 19 TC 561*. This case, which quoted and approved the famous dictum of Rowlatt J that ‘receivability without receipt is nothing’ (from *Leigh v CIR, (1928) 11 TC 590* at p 595) actually related to an entitlement to interest which the creditor voluntarily deferred and so the same principle must apply still more where the interest is unpaid but the creditor would have liked to have it. Despite (or because of) its age, this principle has been upheld in successive decisions, including *Girvan v Orange Personal Communications Services Ltd Ch D, [1998] STC 567*. See further *Taxation Treatment of Interest and Loan Relationships* chapter 4 (published by Bloomsbury Professional).

Capital losses—‘debt on a security’

8.23 Where a debt is repaid in full or in part upon a distribution in administration or liquidation (or on receivership or a voluntary arrangement), or ceases to have any value, the creditor’s tax position depends on whether or not the debt is a ‘debt on a security’. This phrase is not defined in the legislation though the definition of security in *TCGA 1992, s 132(3)(b)* applies which is that:

‘“security” includes any loan stock or similar security whether of the Government of the United Kingdom or of any other government, or of any public or local authority in the United Kingdom or elsewhere, or of any company, and whether secured or unsecured.’

This is not an enormously helpful definition though it makes clear that relief may be available for debts of foreign as well as UK companies and whether or

not they are secured debts. The Inland Revenue stated in 1970 that the definition is regarded as exhaustive and that loan stock ‘implies in general a class of debt the holdings in which are transferable by purchase and sale’ (IRPR 11, June 1970). Since then, the meaning of the expression ‘debt on a security’ has been considered in a number of cases, notably *Cleveleys Investment Trust Co v CIR CS 1971, 47 TC 300*; *Aberdeen Construction Group Ltd v CIR HL 1978, 52 TC 281*; *W T Ramsay Ltd v CIR HL 1981, 54 TC 101*; and more recently *Taylor Clark International Ltd v Lewis CA, [1998] STC 1259*. These cases confirm that the phrase does not mean a ‘secured loan’. HMRC’s current view is to be found in IR Man (CG), paras 53420–53436.

8.24 Where the creditor is the original creditor under a debt, he can realise a chargeable loss *only* if the debt is a ‘debt on a security’, or relief is available under *TCGA s 253*—see further below. If the loan is a ‘debt on a security’, or he is not the original creditor, the satisfaction of a debt or part of it will be treated as a disposal for capital gains purposes, so that any distribution will give rise to a part disposal. Alternatively, the creditor may be eligible to make a negligible value claim under *TCGA 1992, s 24(2)* in the same way as a shareholder (see **8.2** above). However, this will *not* be available if the loan is a qualifying corporate bond—see **8.27** below.

8.25 If a debt is satisfied in whole or in part by the transfer of an asset (i.e. a distribution *in specie*), then there is potentially both a disposal of the debt by the creditor (under *TCGA 1992, s 251*) and a disposal by the company. This is subject to specific relieving provisions—notably *TCGA 1992, ss 132 and 135* (reorganisations, etc.) and *171* (intra-group transfers). A measure of relief is also given by *TCGA 1992, s 251(3)* which provides as follows:

‘(3) Where property is acquired by a creditor in satisfaction of his debt or part of it, then subject to the provisions of section 132 and 135 the property shall not be treated as disposed of by the debtor or acquired by the creditor for a consideration greater than its market value at the time of the creditor’s acquisition of it; but if under sub-section (1) above (and in a case not falling within either section 132 or 135) no chargeable gain is to accrue on a disposal of the debt by the creditor (that is the original creditor), and a chargeable gain accrues to him on a disposal by him of the property, the amount of the chargeable gain shall (where necessary) be reduced so as not to exceed the chargeable gain which would have accrued if he had acquired the property for a consideration equal to the amount of the debt or that part of it.’

This sub-section has two effects: first, if a creditor has received an asset in satisfaction of his debt, the asset is not to be taken as having been acquired for a consideration greater than the market value of the asset. The effect is that (subject to *sections 132 and 135*) the base cost of the asset—and any gain or loss on disposal of the loan—is calculated based on the market value of the asset when acquired by the creditor, not any greater sum (e.g. face value of the loan). Secondly, where an asset is transferred to the original creditor under a debt which is not a debt on a security and the asset is a chargeable asset for CGT purposes which is then sold at a gain, the creditor’s gain is reduced to the

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amount which it would have been if his base cost in the asset were equal to the amount of the debt.

8.26 *TCGA 1992, s 251(4)* restricts loss relief in respect of debts acquired from the original creditor (therefore, debts which would have been exempt from CGT in his hands if not debts on a security). Where a debt has been so acquired, directly or through a series of purchases through persons connected with the person making the disposal, any loss is not an allowable loss. This applies whether or not the debt is actually a debt on a security.

Capital losses—qualifying corporate bonds

8.27 Relief for a capital loss is not available if the loan on which the loss is sustained is a ‘qualifying corporate bond’. This term is defined in *TCGA 1992, s 117*. The definition is complex but in principle:

- (a) A loan relationship is always a ‘qualifying corporate bond’ for a creditor which is within the scope of corporation tax. [*TCGA 1992, s 117(1A)*].
- (b) For other creditors, the basic definition is ‘a security ...
 - (i) the debt on which represents and has at all times represented a normal commercial loan; and
 - (ii) which is expressed in sterling and in respect of which no provision is made for conversion into, or redemption in, a currency other than sterling’.

[*TCGA 1992, 117(2)*].

The definition of ‘security’ in *TCGA 1992, s 132(3)(b)* includes all loan stock of UK and foreign companies. ‘Normal commercial loan’ has the meaning in *ICTA 1988, Sch 18 para 1(5)*. A detailed discussion of the definition and related case law is outside the scope of this book.

Capital losses—loans to traders

8.28 A relief for capital losses in respect of ‘loans to traders’ is given by *TCGA 1992, s 253* where the loan is not a ‘debt on a security’ and was made after 11 April 1978. The section applies to a ‘qualifying loan’, that is, a loan made to a UK resident borrower where the money lent is used wholly for the purposes of a trade carried on by the borrower or by another trading company in the same group (to which the money is lent), not being a trade which consists of or includes the lending of money. [*TCGA 1992, s 253(1)(a)*]. This includes money used for setting up a trade which is subsequently carried on by the borrower (or other group company as above). It is doubtful that the restriction to UK resident borrowers is sustainable as a matter of EU law (see for a somewhat similar issue, *Rewe Zentralfinanz eG v Finanzamt Koeln-Mitte (Case C-347/04) ECJ 2007, [2008] STC 2785*). Further conditions include: that an outstanding amount of the loan has become irrecoverable; that the claimant has not assigned his right to recover that amount; and that the claimant and borrower were not

each other's spouses or companies in the same group at the time the loan was made or at any subsequent time. [TCGA 1992, s 253(3)]. A group for this purpose is a 75 per cent group within TCGA 1992, s 170. [TCGA 1992, s 253(14)]. There is a provision for clawback of relief where an amount in respect of which relief has been claimed by the company or another company in the group is subsequently recovered. [TCGA 1992, s 253(5), (8)]. The loss strictly arises at the date of the claim but, under TCGA 1992, s 253(3A), the loss may be claimed to have arisen at an earlier time within two years before the beginning of the accounting period or year of assessment in which the claim is made, provided the amount claimed was also irrecoverable at the date specified in the claim. A related relief for loans to traders on qualifying corporate bonds was withdrawn but is still available for loans made before 16 March 1998. [TCGA 1992, ss 254–255]. The loan does not have to be still in existence at the time the claim is made (according to the Special Commissioners in *Crosby and others (Trustees) v Broadhurst*, [2004] STC (SCD) 348). A case on this provision which is of some interest in debt restructuring is *Robson v Mitchell CA*, [2005] STC 893. In that case, the appellant had made a loan to the company to pay off an overdraft. He lost his appeal because he was unable to persuade the High Court or Court of Appeal to interfere with the Commissioners' decision that the money had not been expended by the company for the purposes of a trade. However, the judges expressed no doubts in finding that the purposes which had to be considered were those of the original expenditure (i.e. that financed by the bank loan) and that they should not take a narrow view that the only purpose to be considered was the purpose of refinancing. There is a related relief for guarantors—see **8.54** below.

Losses in respect of trade debts

8.29 The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for tax purposes (see *CTA 2009, s 46* for corporation tax and *ITTOIA 2005, s 25* for income tax). The issue which arises in insolvency is whether any such adjustment arises in respect of 'bad debts' or 'impairment losses' reflected in the accounts.

8.30 As with other rules, there is now a distinction between income and corporation tax, which are covered by separate legislation following the tax law rewrite. The old rules about bad and doubtful debts formerly in *ICTA 1988, s 74(1)(j)* have come through the rewrite for income tax purposes as *ITTOIA 2005, s 35* with the wording changed to remove the word 'doubtful' from the text of the section but not the head note (this is not an improvement) but otherwise in the same terms. There are two comparable provisions for companies—the rules under the 'loan relationships' provisions and the specific replacement for *ICTA 1988, s 74(1)(j)* which is *CTA 2009, s 55*. The 'loan relationships' rules are covered in **8.41–8.45** below and Chapter 12. It should be noted that trade debts are now in most cases 'relevant non-lending relationships' except possibly in relation to barter transactions (since this will not involve 'payment' for the purposes of the amended *CTA 2009, s 479(3)*). *Section 55* is therefore only relevant in rare situations of non-money debts

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arising from trading transactions, such as barter. *Section 55* uses essentially the same words as the income tax provision apart from the terminology of 'impairment loss' rather than 'bad debt'. To avoid prolixity, the following discussion focuses on the income tax position although the same principles will generally apply for corporation tax where *section 55* is relevant.

8.31 The following discussion is concerned with trade debts arising to unincorporated businesses which carry on a trade which is not a financial trade, although much of the law is equally applicable to financial traders.

8.32 Where, in carrying on his trade, a taxpayer becomes a creditor of a company which proves insolvent or, in certain cases, a taxpayer pays up under a guarantee given in respect of an insolvent company's indebtedness, he will normally be eligible for relief for the bad or doubtful debt recognised in his accounts or in respect of any outright payment which he makes, provided various hurdles can be overcome. It is essential that the debt should arise not merely in the course of, but also for the purposes of, the trade, since otherwise a deduction will be precluded by either *ITTOIA 2005, s 34(1)(a)*, which precludes deductions for expenses not 'incurred wholly and exclusively for the purposes of the trade ...', or *ITTOIA 2005, s 34(1)(b)*, which prohibits the deduction of 'losses not connected with or arising out of the trade', or possibly *ITTOIA 2005, s 33*, prohibiting the deduction of 'items of a capital nature'. Where the trade is not of itself a financial trade, HMRC put the test in terms whether 'the lending of money is an operation ancillary to and an integral part of another existing trade' (*IR Man (BIM)*, para 42720). This terminology appears in *Nuclear Electric Ltd v Bradley HL*, [1996] *STC* 405. Earlier cases which are more directly relevant show that the question is one of fact, as is illustrated by a number of cases concerning advances by traders, of which the leading one is *Reid's Brewery Co Ltd v Male QB* 1891, 3 *TC* 279 where a brewing company carried on a money-lending business as an 'essentially necessary' adjunct to its brewery business and was held eligible to deduct losses incurred in its money-lending business from the profits of its trade. This case was distinguished in *CIR v Hagart & Burn-Murdoch HL* 1929, 14 *TC* 433 where a firm of Scottish solicitors which lent money to clients 'in the course of' its legal business was not eligible to deduct the losses it incurred since the money-lending business was held to be too far removed from the practice as solicitors to be regarded as one of the purposes of the business, or 'essential and necessary' to it. The latter case was followed in *Bury & Walkers v Phillips Ch D* 1951, 32 *TC* 198 but distinguished in a third case about solicitors who gave a guarantee of a client's indebtedness, on the grounds, first, that there was no separate consideration for the guarantee which was therefore incapable of constituting a separate venture and, secondly, and perhaps more convincingly, because the Commissioners had found as a matter of fact that at least some solicitors made a practice of giving guarantees (*Jennings v Barfield Ch D* 1962, 40 *TC* 365). Factors which are likely to prove important in showing whether a guarantee is given in the 'ordinary course' will include the frequency with which guarantees have been given by the trader, the nature of his business and whether an arm's length fee has been charged.

8.33 Where a deduction is not precluded by the provisions just mentioned, then a provision for bad or doubtful debts properly made in accordance with commercial (i.e. accounting) practice in the trader's accounts will be deductible, provided it does not offend the further prohibition in *ITTOIA 2005, s 35*, which says that:

'35 Bad and doubtful debts

(1) In calculating the profits of a trade, no deduction is allowed for a debt owed to the person carrying on the trade, except so far as—

- (a) the debt is bad,
- (b) the debt is estimated to be bad, or
- (c) the debt is released wholly and exclusively for the purposes of the trade as part of a statutory insolvency arrangement.

(2) If the debt is bankrupt or insolvent, the whole of the debt is estimated to be bad for the purposes of subsection (1)(b), except so far as any amount may reasonably be expected to be received on the debt.'

'Statutory insolvency arrangement' has the same meaning as described in **6.5** above. The wording in *section 35* is a simplified version of the old *ICTA 1988, s 74(1)(j)*. The words until 1996 read 'bad debt proved to be such'. HMRC consider that this change has no practical significance (see IR Man (BIM), para 42701).

8.34 *ITTOIA 2005, s 35(1)(a)* contemplates bad and doubtful debt provisions in three circumstances. The first is where the debt is bad. The onus here is on the taxpayer. 'Bad', in this context, has been held by the Special Commissioners to mean wholly bad (see *Taylor v Clatworthy, [1996] SSCD 506*). In many cases it will be obvious enough when a debt is bad; in other cases this will be a matter for accounting practice and negotiation with the Inspector. In practice, therefore, aside from actual releases discussed below, the more important provision is *ITTOIA 2005, s 35(1)(b)*, giving relief for debts 'estimated to be bad' (not called 'doubtful' any more but as the term is still in the head note, and it is useful shorthand, it will still be used below). As is implicit in the wording, there is no overriding principle that the debtor company must be formally insolvent before a provision for a bad or doubtful debt can be made (*Dinshaw v Bombay Commissioner of Income Tax PC 1934, 50 TLR 527*). What is required is a *bona fide* estimate of the value of the debt in the year in question—as Rowlatt J put it in *Anderton and Halstead Ltd v Birrell KB 1931, 16 TC 200* at p 209:

'What the statute requires, therefore, is an estimate to what extent a debt is bad, and this is for the purpose of a profit and loss account. Such an estimate is not a prophecy to be judged as to its truth by after events, but a valuation of an asset *de praesenti* upon an uncertain future to be judged as to its soundness as an estimate upon the then facts and probabilities.'

In that case, the Inland Revenue's attempt to raise an assessment disallowing relief on a 'discovery' (under what was, prior to the advent of self-assessment,

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TMA 1970, s 29(3)) based on the fact that subsequent advances were made to the debtor was rejected. The basis of the valuation of doubtful debts was further considered in *Absalom v Talbot HL 1944, 26 TC 166* where (by a majority) the House of Lords held that a speculative builder who sold houses on the basis that part of the purchase price was left outstanding, secured on a second mortgage, should bring into account not the full face value of the debt, but its actual value ‘calculated according to the experience of the business’ (per Lord Atkin at p 193). This dictum is an important one to bear in mind during negotiation with HMRC on how bad a debt actually is—the Inspector may be all too tempted to substitute his own opinion for the directors’ commercial judgment, but as Lord Atkin says, this is not the right approach. If the debtor is ‘bankrupt or insolvent’ (which it appears means any type of formal insolvency, including administration, CVA, receivership or liquidation) then it is the whole debt except for any amount reasonably expected to be received which must be taken into account under *ITTOIA 2005, s 35(2)*—this is not a specific requirement for situations apart from insolvency but in practice the same applies. Where the estimate proves to be too low, however, subsequent receipts which exceed the estimate must be brought into account as trading profits in the year of receipt (*Bristow v William Dickinson & Co Ltd CA 1946, 27 TC 157*).

8.35 HMRC have long taken the view that the amount of bad debt relief available is limited to the amount which can be calculated effectively on an objective basis, according to the prospective return in a liquidation as arguably contemplated in the long-standing wording of *ITTOIA 2005, s 35*, and its predecessors. This proved a significant barrier to the viability of CVAs since the amount of the debt written off by a creditor in an insolvency would not necessarily correspond to the amount on which tax relief would be given and full relief would only be available on a basis which could not be challenged if the company went into liquidation. *ITTOIA 2005, s 35* now allows full relief for debts released by a creditor ‘wholly and exclusively for the purposes of his trade’ as part of a statutory insolvency arrangement (see **6.5** above). The ‘wholly and exclusively’ test should be noted: although *section 55* imports the same ‘release’ wording as *section 35*, this test does not have a direct counterpart in *CTA 2009, s 55*. The wording in *section 35* would allow HMRC to challenge relief for a debt released for non-trading purposes such as family reasons or tax avoidance. The motives for which the loan was originally made will also affect the deductibility of any provision if it proves bad or doubtful—see **8.38–8.40** below.

8.36 HMRC practice on allowing bad and doubtful debts for the purposes of *ICTA 1988, s 74* published in Tax Bulletin Issue 12 (August 1994) is now obsolete but they comment on the issue in IR Man (BIM), paras 42701–42750. A number of the points raised are worth commenting on:

- (a) HMRC state that the company’s accounting provision is a ‘useful starting point in quantifying the amount of any deduction available in respect of doubtful debts ... provided this is based on a separate valuation of each debt’ and indicate that a general reserve should not be admitted as a deduction if made without regard to the circumstances of the particular debtors. See IR Man (BIM), para 42701. Though not stated, the authority

for this is presumably (as well as dicta in the cases previously cited here) the cases on provisions for expenses such as *Owen v Southern Railway of Peru Ltd HL 1956, 36 TC 602* and *CIR v Titaghur Jute Factory Co Ltd CS, [1978] STC 166*. This legislation evidently means that each debt must be considered individually (the wording of *ICTA 1988, s 74(1)(j)* before amendment in 1994 was even clearer as it referred to debts ‘respectively’ estimated to be bad).

- (b) HMRC confirm (in IR Man (BIM), para 42705) that they accept that in some circumstances, where accounting practice permits, events arising after the balance sheet may need to be reflected in the bad and doubtful debt provisions and will be allowable as deductions for tax purposes. HMRC say that provisions will be allowed in such cases where:
- a debt existed at the balance sheet date;
 - the creditor at that date had no reason to believe he would not be paid; but
 - before the accounts were finalised he discovered that the financial position of the debtor at the balance sheet date was such that the amount due was, even at that time, unlikely to be paid.

HMRC give the example of a debtor which goes into administration or liquidation shortly after the balance sheet date. However, the Inspector’s Manual, IM 636, goes further than the Bulletin and indicates that an allowable provision will not be accepted as arising where:

- a debt existed at the balance sheet date and
- at that date the debtor had the capacity to pay but
- before the accounts were finalised, circumstances arose which rendered the debt doubtful.

A case in which a taxpayer failed before the Special Commissioners on precisely this point was *Walker v O’Connor (Insp of Taxes) Sp C, [1996] SSCD 218* (Decision No 74). *Thompson v CIR, [2005] STC (SCD) 320* highlights another pitfall raised by the question of timing of bad debts—in that case the taxpayer was unable to claim relief for the bad debt because the years in question had been closed following agreement under *TMA 1970, s 54*. He was also precluded from making an error or mistake claim under *TMA 1970, s 33* because in the years in question no tax had been charged.

- (c) IR Man (BIM), para 42710 notes that typical circumstances where a bad debt may be challenged are where debtor and creditor are relatives or companies in the same group, or the debtor has made a composition with the creditor to the exclusion of other creditors. It is accepted, though, that (presumably in the last case) the amount may be admissible as representing a special discount or allowance. The position for intra-group write-offs and guarantees is discussed in detail in **8.38–8.40** below. In the last of the three circumstances mentioned in the Manual, while HMRC are undoubtedly prudent to sound a note of caution to Inspectors, if

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parties at arm's length agreed in good faith to compromise a trade debt, it would be surprising if this were not permitted as reducing profits for tax purposes.

- (d) IR Man (BIM), para 42710 states that the mere fact that a debtor is a slow payer and a debt has been outstanding for a long time does not of itself cause a provision to be allowable since the debt cannot be estimated to be bad. This may be right in law but, in the writer's experience, it is an extreme statement of HMRC's position and does not really reflect HMRC practice where in many cases a bad debt provision will be allowed by individual Inspectors either in whole or in part where it is drawn up on the basis of debts which have been outstanding for a certain period (provided the taxpayer is consistent and promptly writes back debts provided for if they actually are paid).
- (e) HMRC have also indicated (in IR Man (BIM), para 42715) the kind of information which will be requested to establish whether a debt provision is eligible for deduction. This will involve identifying each debt involved and establishing:
- how the extent of its doubtfulness was evaluated,
 - when this was done,
 - by whom and,
 - what specific information was used at arriving at that valuation.

They state that:

'Typically, this requires sight of all the evidence available, at the relevant date, to the taxpayer creditor regarding the creditworthiness of the debtor. This will include copies of all correspondence, both internal (such as memos and minutes of meetings at which the matter was considered) and external (correspondence with the debtor, solicitors, banks, factoring agencies, etc. and any reports obtained concerning the financial position of the debtor), relating to the transactions in question covering the period up until the time a reserve for the debt was entered in the creditor's books.'

8.37 The comprehensive nature of the information which HMRC (not surprisingly) require emphasises an issue which has caused some controversy, namely the extent to which an objective test by HMRC, as against a subjective test (the reasonable opinion of the company's directors, as experienced men of business), is appropriate to determine what is or is not a doubtful debt and the 'amount which may reasonably be expected to be received on the debt'. This situation was especially material before 30 November 1993 when the exclusion was introduced for debts released 'wholly and exclusively for the purposes of' a trade as part of a relevant arrangement or compromise. The Revenue had previously argued in a number of cases that amounts released in CVAs should not give rise to bad debt relief if in a liquidation the creditor could have recovered a greater sum. A debatable point in itself, this proved a significant deterrent to CVAs and the law was changed. An amount released in the course of a CVA or CA 2006, Pt 26 scheme will now normally give rise to bad debt

relief. See further **6.22** above. The point can still be important in other contexts, however, and the cases referred to in **8.32** above should be borne in mind.

Bad debts from related party debts and payments

8.38 An area of particular sensitivity is the deductibility of bad debts where an advance has been made to a related person and written off, or an intra-group guarantee is called. In addition to any other arguments open to HMRC under general principles, a bad debt claimed in these circumstances may well be challenged on the basis that it was not incurred wholly and exclusively for the purposes of the lender's trade. The issue will be the motive for the advance, and no deduction will be available unless the taxpayer can show that his motives are such as to avoid the restriction in *ITTOIA*, s 34(1)(a) (see **8.32** above). In *Garforth v Tankard Carpets Ltd Ch D*, [1980] STC 251, a case often quoted by HMRC, a company guaranteed the indebtedness of its associated company and gave a charge over its own assets by way of security. When the bank called in the guarantee, the taxpayer sought a tax deduction for the payment. The judge, Walton J, held that it was not sufficient to show that the guarantee was in the taxpayer's best interest—it was necessary to go further and show that this was the whole purpose. He commented in extremely wide terms that:

'It must in the nature of things be extremely difficult for any directors of two associated companies in the position of [the taxpayer company] 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. In my judgment, Commissioners should be extremely slow in coming to any conclusion that the act was done solely for the benefit of the trade of one of the companies concerned, and should in general do so only where there are wholly separate findings of primary fact not depending on the say-so of the directors concerned. I cannot resist the impression that in 99 cases out of 100 the correct primary fact to find will be that which was in fact found in this case; namely that in such a situation as the present the interests of all the companies were considered together. This is in accord with all the probabilities in the present and, indeed, most foreseeable cases.'

This decision was followed on similar facts by the Special Commissioners in *Redkite Ltd v Inspector of Taxes SpC*, [1996] SSCD 501.

8.39 The *Garforth* case is of direct relevance to intra-group loans, not least because the judge stated (at p 258h) that he did 'not think that there is any real difference between giving a guarantee and the loan of money to the company concerned'. However, it is considered that the comments just quoted (which the judge himself implicitly accepted were *obiter*) go altogether too far and that it is essential for the facts of individual cases to be determined on their own merits (indeed, two days later the same judge did *not* find there to have been duality in a company meeting certain expenditure of its associate—see *Robinson v Scott*

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Bader Ltd, [1980] STC 241, subsequently affirmed by the Court of Appeal in [1981] STC 436). Another case where the Revenue successfully showed that payments under a guarantee of an associate's indebtedness were not tax deductible was *Milnes v J Beam Group Ltd Ch D*, [1975] STC 487.

8.40 An alternative argument, traditionally much favoured by Inspectors (and put in *Milnes v J Beam Group Ltd*, referred to above) is that a payment made to discharge an associate's indebtedness is a capital payment. It will be fatal to obtaining a tax deduction if the purpose of the payment (or loan) was to keep the associate in business (see *English Crown Spelter Co Ltd v Baker KBD 1908*, 5 TC 327; *CIR v Huntley & Palmers 1928 12 TC 1209*; *Marshall Richards Machine Co Ltd v Jewitt 36 TC 511*; and also *Taylor v Clatworthy SpC*, [1996] SSCD 506). The point will also be particularly relevant where the payment is associated with a disposal of the associate concerned. That was the situation in the important case of *Lawson v Johnson Matthey plc Ch D*, [1981] STC 149, CA [1991] STC 259, HL [1992] STC 466. The facts were that the taxpayer was a company dealing in precious metals whose subsidiary, a bank, referred to as JMB, got into financial difficulties. The Bank of England agreed to purchase the share capital of JMB for £1, on condition that the taxpayer injected £50m into JMB before sale—and the transaction proceeded on this basis. HMRC argued three points before the Commissioners—first, that the payment was to procure the disposal of a capital asset, namely the shares in the Bank; secondly, that the payment was made in part to free the taxpayer from liabilities of a capital nature (its undertaking to the regulator); and thirdly, that the payment was for the preservation of the goodwill not of the taxpayer company exclusively but of both it and its other group companies. The Commissioners rejected the second and third arguments on the facts and no arguments were made on them in the higher courts. The Revenue persisted with the argument that the payment was to enable the taxpayer to get rid of a capital asset successfully in the High Court and Court of Appeal. The taxpayer was, however, successful in the House of Lords, on the grounds that the payment was made to protect the existing business from collapse, as a contribution to the rescue of JMB. Lords Keith and Goff, in particular, laid stress on the fact that the payment was made to JMB and not to the Bank of England. *Johnson Matthey* was distinguished in *Stone & Temple Ltd v Waters Ch D 1994*, [1995] STC 1, where the taxpayer made loans to a business associate, a Mr Hordo, with a view to protecting an indirect interest in a lease. The judge gave short shrift to the analogy with *Johnson Matthey*, holding that the debt was a capital asset.

Relief for creditors which are companies

8.41 Relief for creditors under the loan relationships legislation is discussed in detail in Chapter 12. The following outline is included to complete the picture for creditors generally, and sets out the situations when relief is available for their losses.

Definition of ‘connected persons’

8.42 If a company is insolvent and fails to repay a creditor under a ‘loan relationship’ within *CTA 2009, Pt 5*, or an amount which is treated as such under *CTA 2009, Pt 6*, the tax treatment of the creditor (and the debtor) depends on whether the lender and borrower are connected so that the debt is a ‘connected companies relationship’. This is discussed in Chapter 12 (for the discussion of connected companies relationships see **12.10–12.13** below). This control test is, in fact, essentially the same test as the test under *ICTA 1988, s 840* except as applies to partnerships. Very similar issues are raised as are discussed in **5.76–5.80** above and it may be noted that the interpretation applied by HMRC has been precisely the opposite to the interpretation applied in administrations. In other words, it is not apparent that the definition could apply to a relationship involving a company (creditor or debtor) that was in the course of an administration or liquidation. If it is the debtor which is insolvent but not the creditor, the creditor company as shareholder does not have the power to secure the manner in which the affairs of a company under these procedures are conducted; while if it is the creditor which is insolvent, an administrator or receiver does not have the power to act in accordance with his own wishes since he acts in accordance with the statutory schemes, for the benefit of the company or its creditors as the case may be.

Relief for losses on ‘loan relationships’—unconnected persons

8.43 Where the parties are not connected, the creditor will get bad debt relief automatically if it uses fair value accounting (since the reduction in market value will be recorded as a debit in his accounts as the value of the debt decreases). An amortised cost basis, too, will adjust assets and liabilities for ‘any impairment, repayment or release’ but subject to this the full amount of the liability will be shown at cost adjusted for amortisation. Thus, interest and other amounts due to it will continue to accrue, and be taxable irrespective of whether amounts are paid, until such time as an impairment can be justified or there is a release. Releases are discussed in **12.38–12.43** below. The test whether a debt is impaired is the accounting test set out in IAS 39, which is summarised by HMRC in *IR Man (Corporate Finance)*, para 16230 (July 2007). HMRC make clear in *IR Man (Corporate Finance)*, para 5153 that they consider the test to be different from the previous test for bad and doubtful debts which was the subject of the case law referred to in **8.29–8.37** above. It is accepted that in some cases, the relief now given will exceed the relief under the previous rules as it ‘is not restricted to cases where the creditor feels a default is probably (or where it has already occurred)’ but ‘may be recognised where there is data indicating that the estimated future cash flows from a group of assets will decrease’.

Relief for losses on ‘loan relationships’—connected persons

8.44 Where a loan creditor is in a connected companies relationship, because the creditor is ‘connected with’ the company for the purposes of *CTA*

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2009, s 466 (see **12.10–12.13** below), *CTA 2009, s 354* substantially restricts relief for impairment losses and releases. Relief is only available in the specific situations set out in *sections 356 and 357*, namely:

- (a) The relief for ‘debt-equity swaps’ in *CTA 2009, s 356*. This relief is crucial in restructuring the debt of insolvent companies and applies where the liability is discharged in consideration of, or of an entitlement to, ordinary shares in the company and there was otherwise no ‘connection’ between the company and its creditor before the shares (or entitlement) were acquired. This relief is discussed further at **12.44–12.49** below.
- (b) The relief introduced to remedy the anomaly revealed by the case of *Re Toshoku Finance UK plc HL, [2002] STC 6*, discussed in **4.33–4.35** above. As will be recalled, in that case a company in liquidation was held to be taxable on income accruing on a debt due from its insolvent associate, even though no income would ever actually be received and the income was purely notional. *CTA 2009, s 357* remedies this absurd situation by providing that bad debt relief is available where an amount accrues to a creditor at ‘the relevant time’ and the creditor company:
 - (i) is in insolvent liquidation (as defined)—in which case the relevant time is any time in the winding up;
 - (ii) is in insolvent administration (as defined)—in which case the relevant time is any time in the course of the administration;
 - (iii) is in insolvent administrative receivership (as defined)—in which case the relevant time is any time when the appointment of the administrative receiver is in force;
 - (iv) has had a provisional liquidator appointed under *IA 1986, s 135* or the Northern Ireland equivalent—in which case the relevant time is any time when the appointment is in force; or
 - (v) is in the corresponding situation under the law of a country outside the UK—in which case the relevant time is the time corresponding to the times above.

It will be noted that this provision giving relief for the creditors does not include CVAs or schemes of arrangement under *CA 2006, Pt 26*.

8.45 Apart from the restriction for connected companies loan relationships, the transfer pricing rules (which apply more widely) may also have to be considered—see **12.22–12.23** below.

Associated expenses

8.46 Relief under the loan relationship provisions is not confined to losses of principal and interest on a loan. *CTA 2009, s 307(3)(c)* also permits a deduction for ‘all charges and expenses incurred by the company under or for the purposes of [its loan] relationships and [related] transactions’. The various tests which must be satisfied in obtaining a deduction under these provisions are summarised in **12.21** below. In considering the deductions available for creditors, the limitation in *CTA 2009, s 304* on relief for the expenses of taking

steps for the receipt of payments under loan relationships will be especially relevant. The wording extends quite unambiguously to the incidental costs (e.g. legal fees) of a creditor in making the loan, or disposing of his debt. Apart from the deductibility of insolvency practitioner's expenses (considered in **5.19–5.21** above), the question most at issue in an insolvency will be how far the creditor's expenses for enforcing, or obtaining payment under, the debt will be deductible. The expense of instructing a lawyer or other person to recover a debt is permitted under this provision, as well as steps taken in the course of enforcement of the debt or enforcement of security, negotiation and taking new security which will be expenses in ensuring the receipt of payments.

8.47 Where the debt is restructured and part of it is released, the transaction should be a 'related transaction' (see **12.9** below) and accordingly relief is permitted for expenses such as legal fees incurred directly in entering into the release. Where a new debt is acquired, the attributable expenses should normally be eligible for relief as expenses in bringing the new relationship into existence.

8.48 Although relief is given for expenses of collecting debts under the loan relationships rules, the relief given to non-corporate creditors for such expenses is much more limited. A person who collects debts in the course of a trade (if they are trade debts for goods or services supplied or if it is a financial trade or one of dealing in debts) may be eligible for relief under general principles. *TCGA 1992, s 38* treats various matters as allowable expenditure in computing the gain on disposal of an asset but does not expressly refer to costs relating to debts, presumably because most debts are not chargeable assets (see **8.17** above). However, it would seem that, at the least, legal expenses on enforcing a debt should be regarded as 'expenditure wholly and exclusively incurred ... in establishing ... title to, or to a right over ...' the debt within *TCGA 1992, s 38(1)(b)*.