TC06610

Appeal number: TC/2016/06482

Capital gains tax –whether writing off part of a qualifying loan created an allowable loss under section 253(3) TCGA 1992- yes, whether section 253(12) applies to deny the allowable loss- No, whether an unrealistic hope that the balance of the loan would be repaid affect the objective assessment that the part written off was irrecoverable - no. Appeal allowed.

FIRST-TIER TRIBUNAL
TAX CHAMBER

DOUGLAS ATHERLEY **Appellant**

- and -

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

TRIBUNAL: JUDGE GETHING
MEMBER Mr David Williams CTA (Fellow)

Sitting in public in Court 30 at Taylor House, Rosebery Avenue, London on Wednesday 18 July 2018 at 10.00am

Carl Barwick of Westbury Accountants for the Appellant

Mr Tony Burke presenting officer of HM Revenue and Customs, for the Respondents

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DECISION

1. This appeal concerns the write off of part of a qualifying loan made by the Appellant to Kinari Design Limited ("Kinari) the company of which the Appellant was the sole owner and through which he conducted a high end interior design business, in circumstances where Kinari had not ceased trading. It raises two issues, whether:

(1) an allowable loss arose in respect of the part of the loan written off in January 2013 under section 253(3) Taxation of Chargeable Gains Tax Act 1992 (TCGA); and

(2) the loss was not allowable because section 253(12) TCGA 1992 applies.

2. For the reasons set out below we allow the appeal in full.

3. We heard evidence from the Appellant. We had accounts for each of the years ended October 2011, 2012, 2013 and 2014.

4. We find the relevant facts are as follows:

(1) The Appellant had been a stock broker but had an interest in interior design. He had undertaken the restoration of two residential properties, one in London and another in New York while engaged as a stock broker and had undertaken study in design at first on a part-time basis and then on a full-time basis after his work on the London and new York properties had been recognised in industry journals. He decided to make a living as an interior designer, and set up Kinari in 2002.

(2) He began in the high end residential market. He used his two restoration projects as part of his portfolio.

(3) The high end residential market requires substantial engagement with the clients. The clients want only to engage with the principal designer and the business does not allow a designer to leverage his skills.

(4) The Appellant decided to break into the commercial property market which can be very lucrative. There are a number of problems in establishing a business in this sector. The first is the need to be invited to pitch for lucrative work which requires connections/contacts, the second is the cost of pitching (a single pitch can cost up to £250,000), the third is the terms of engagement which might mean the interior designer gets a percentage of the sales proceeds of the property when sold but the cost of designing and providing the furnishings would fall to the designer unless the designer can secure a loan of them. Often this is not possible if the designer is not a well-known name. In such circumstances the designer would have to buy furnishings. If the ultimate purchaser of the apartment does not wish to buy the furnishings the designer will have to bear the cost of transport and insurance of those that were borrowed

and bear the entire cost of those that were not borrowed, ending up owning them. Even if invited to pitch a designer may not secure the project because of the lack of a large design team or insufficient experience.

(5) The Appellant funded Kinari through a loan account rather than through share capital. Kinari had one share in issue with a nominal value of £1. There was no share premium.

(6) Kinari made the following losses:

		£
(a)	2010	(1,243)
(b)	2011	(131,559)
(c)	2012	(205,661)
(d)	2013	(114,628) (before taking into account the profit that arose from the release of £350,000 of the loan)
(e)	2014	(185,027)

(7) The sums owing to the appellant on his loan account were as follows:

(a)	31 October 2010	£87,037
(b)	31 October 2011	£239,020
(c)	31 October 2012	£601,638
(d)	31 October 2013	£291,488 (after write off of £350,000)
(e)	31 October 2014	£341,043

(8) The Appellant had discussed the viability of the business with his accountant on many occasions in view of the qualification in the accounts that Kinari was a going concern but only because of the continued loan funding by the Appellant. The Appellant was enabled to carry on this business notwithstanding its lack of profitability owing to his wife's continued employment in the financial services industry.

(9) In January 2013 the Appellant discussed the prospect of being repaid the full amount of the loan to Kinari. The global and UK economy had consistently under-performed against forecasts since 2008. At this stage the loan was some £616,959. The Appellant decided to write off £350,000 of the £616,959 loan and to wind down the business in an orderly fashion ensuring all external creditors were paid. The wind-down would ensure the good reputation of Appellant and Kinari were maintained with the market and his contracts. Leaving unpaid external creditors was not a possibility. Whereas in the USA insolvency and bankruptcy is seen in a different light that was not the case outside the USA.

(10) It was in 2013 that Kinari had been paid fees for a very large high profile project for a property belonging to the Ritz Carlton hotel group in Chicago that had come out of the blue in an earlier year. Kinari provided the interior design of a show apartment and Kinari received a percentage of the sales proceeds of

the apartment. The accounts for the full year show the direct costs incurred that year were slightly smaller than the fees (by approximately £75,000) but after the administration costs (which were around c£200,000 each year) a significant loss was incurred. Many of the direct costs were unexpected for the reasons mentioned in para 4(4) above.

(11) A redundancy programme was implemented by Kinari at the end of 2014 and the layoffs occurred in 2015.

(12) Kinari ceased trading altogether in 2016.

The relevant legislation

5. Section 253 Relief for loans to traders

"(1) In this section "a qualifying loan" means a loan in the case of which:

(a) the money lent is used by the borrower wholly for the purposes of a trade carried on by him, not being a trade which consists of or includes the lending of money, and

(b) the borrower is resident in the United Kingdom, and

(c) the borrower's debt is not a debt on a security as defined in section 132;

and for the purposes of paragraph (a) above money used by a borrower for setting up a trade which is subsequently carried on by him shall be treated as used for the purposes of that trade."

"(3) Where a person who has made a qualifying loan makes a claim and at that time-

(a) any outstanding amount of principal on the loan has become irrecoverable

(b) ….

(c) ….

then, to the extent that the amount is not an amount which, in a case of the claimant, falls to be brought into account as a debit given for the purposes of Part 5 CTA 2009 (loan relationships), this Act shall have effect as if an allowable loss equal to that amount had accrued to the claimant at the time of the claim or …. any earlier time specified in the claim."

"(12) References in this section to an amount having become irrecoverable do not include references to cases where the amount has become irrecoverable in consequence of the terms of the loan, of any arrangements of which the loan forms part, or of any act or omission by the lender, or in a case within subsection(4) above the guarantor."

6. It was agreed that the loan was a qualifying loan.

HMRC submissions

7. HMRC argued that the £350,000 loan that was written off was not irrecoverable at the date of the claim because the Appellant had considered it was theoretically possible for the remaining balance to be recovered, and that a loan could not be written off in part only while Kinari continued to trade. Also the Appellant went on to lend a further £65,554 after the write off which is indicative the Appellant thought the loan was repayable.

8. Section 253(12) applied to restrict the loss because the step taken to write off part of the loan was an "act " of the lender as referred to in subsection(12). The write off was only undertaken to generate a loss to match a gain on the disposal of an asset. Kinari could have borrowed from a bank to repay the loan and there would have been no write off and no allowable loss.

9. Kinari could have borrowed from a bank to repay the £350,000.

10. The Appellant wrote off the debt to enable him to set the loss against a matching chargeable gain on another asset in the tax year.

Appellant's submissions

11. The Appellant wrote off £350,000 in January 2013 because he thought that it was irrecoverable. He could not reasonably expect that Kinari would ever be able to repay it as Kinari had made losses every year since 2010 and although Kinari had secured some high profile instructions Kinari had not broken into the big time. Kinari lacked track record and scale of operations to secure a continuous flow of high profile lucrative instructions. In the following year the Appellant decided to wind down the business in an orderly way to ensure creditors were paid to protect his and Kinari's reputation and safeguard his good contacts. The write off of the debt was not tax-motivated.

12. The Appellant's decision to write off part only of the loan was because there was a theoretical possibility albeit exceedingly remote that a high profile lucrative instruction might come out of the blue. The Ritz Carlton project had come out of the blue. But as expected such an opportunity never materialised. Kinari had been loss making since 2010 and continued to make losses in all the periods prior to its dissolution in 2016.

13. Section 253(3) does not require that the whole of the principal amount of a loan should have become irrecoverable.

14. The mere making of a decision to write off a loan or part of a loan cannot be an act within the meaning of section 253(12) as no relief can ever be claimed for an irrecoverable loan. The section is aimed at contrivances which involve depleting the assets of the borrower thereby artificially preventing repayment of the loan to the lender. Kinari's assets were not depleted by any act or omission which affected Kinari's ability to repay.

Discussion

15. With the exception of £1 share capital, Kinari was funded by a loan from the Appellant. Whether the loan to Kinari was irrecoverable in whole or in part in January 2013 is a question of objective fact. The objective facts are:

5 (1) Kinari had not broken into the big time in interior design and did not have the track record or the necessary scale of operations to do so.

(2) Kinari had made only losses in the previous 3 years and in 2013 it made a loss notwithstanding that it had received the fee for the Ritz Carlton project.

(3) There was a hope but no realistic possibility that a lucrative high profile 10 project could be secured to generate sufficient profit sufficient to repay the loan to the appellant.

(4) In January 2014 the Appellant had decided to discontinue the operations of Kinari in a manner to secure his and Kinari's reputation, to maintain the goodwill of his contacts and to move to Hong Kong.

15 (5) The assessment by the Appellant in January 2013 that £350,000 of the loan to Kinari was irrecoverable was proved not to be fanciful as Kinari continued to make losses until its dissolution in 2016.

We conclude that there was objective evidence that £350,000 of the principal amount of the loan that was written off was irrecoverable in January 2013.

20 16. It is clear that as a matter of fact and law that loans can be written off in part. This is specifically contemplated by the words “any outstanding amount of the principal” in section 253 (3)(a); had it not been so contemplated these words could easily have been omitted. A partial write off is a common feature of creditors' voluntary agreements and is often done to provide some breathing space to a 25 distressed business.

17. The fact that the Appellant thought there was a remote possibility of the balance being repaid does not in our view affect the objective fact that the sum written off was irrecoverable. Subsequent events have proved the assessment of the irrecoverability of the loan to be correct.

30 18. The suggestion that a bank might lend Kinari £350,000 to repay the loan given its loss making track record and lack of assets seems to us fanciful.

19. The Appellant should be entitled to claim an allowable loss equal to the irrecoverable amount of principal on the loan claimed because :

(1) We consider that "act" or "arrangement" of the sort referred to in section 35 253(12) must be the sort of act which would prevent the company repaying the loan. There was no such arrangement or act. A decision to cease to carry on an unprofitable trade cannot be an act to which section 253(12) refers. Nor would a decision to write off part of a loan.

(2) The Appellant suffered the economic loss of £350,000. As Lord Wiberforce said in *WT Ramsay Ltd v Inland Revenue Commissioners* House of Lords [1981] STC 182 b.

"Capital gains tax was created to operate in the real world, not that of make belief... it is not a tax on arithmetical differences."

(3) If the Appellant had made a decision to crystalize a loss in 2013 by writing-off part of the loan to match a corresponding amount of gain realised on the disposal of an asset, this would not affect the availability of the loss in circumstances where the loan is objectively irrecoverable. We note that had the appellant funded Kinari with equity capital rather than loans he could have made a negligible value claim and generated a loss of more than £350,000 as the company had accumulated losses of more than £350,000 in January 2013 and no material assets or book of business.

20. We allow the appeal in full.

21. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

TRIBUNAL JUDGE
HEATHER GETHING

RELEASE DATE: 23 JULY 2018