TC02790

Appeal number: TC/2011/02454

Income tax – company distribution – purchase of own shares – failure to comply with Companies Act requirements but payment actually received by director/shareholder – whether valid distribution – whether amounts actually received by director/shareholder taxable as distribution under s. 209(2)(b) ICTA 88 – no – appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

RUSSELL BAKER **Appellant**

-and-

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

TRIBUNAL: JUDGE KEVIN POOLE
GARETH JONES MBE

Sitting in public in Eastgate House, Cardiff on 4 June 2013

John Brooks of counsel, instructed by Geldards, for the Appellant

Paul Shea, Presenting Officer of HM Revenue and Customs, for the Respondents

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DECISION

Introduction

1. This decision considers whether amounts paid (in cash and in kind) to a director/shareholder of a private company in satisfaction of a purported purchase of own shares by that company are taxable as distributions in the hands of the recipient, notwithstanding the failure to observe the requirements of the Companies Act in respect of such a purchase.

The facts

Introduction

2. We were provided with a Statement of Agreed facts and a bundle of documents, which included a judgment issued by the Gloucester County Court (His Honour Judge Harington) in a claim by Thomson Rail Equipment Limited ("the Company") against the Appellant ("the 2008 Judgment"), which included further useful facts. We did not receive any witness statements or oral testimony from any live witnesses. We find the following facts.

History

3. The Company was incorporated on 23 January 2002. Its original shareholders and directors were the Appellant and one David Thomson, each of whom held ten £1 "A" ordinary shares and ten £1 "B" ordinary shares. The business of the Company was the manufacture of equipment, in particular lifting and handling equipment, for the repair and renewal of railway lines.

Departure of the Appellant from the Company

4. Following a falling out between the Appellant and Mr Thomson, it was agreed towards the end of 2005 that they would go their separate ways. Various ways of achieving that separation were considered but eventually it was decided, on professional advice, that the Appellant's shares in the Company would be purchased by it for a total payment (in cash and in kind) of £120,000, he would resign as a director and company secretary and his employment relationship with the Company would be terminated.

5. The agreement was implemented by means of various resolutions passed at an Extraordinary General Meeting of the Company held on 20 January 2006, at which both the Appellant and Mr Thomson attended. In addition to various minutes dealing briefly with the Appellant's resignation and recording the intention that the charge over his house in favour of the Company's bank would be removed, the resolution set out in Part A of the Schedule to this decision was passed, headed "Shares".

6. This resolution (in common with all the other resolutions recorded in the minutes) was not identified as being an ordinary, extraordinary or special resolution.

However the minutes were signed by both the Appellant and Mr Thomson (who between them held all the issued shares in the Company).

7. As recorded by the resolution, we find that the sum of £25,000 in cash mentioned in it had already been paid by the Company to the Appellant prior to 20 January 2006. The effect of the resolution, if valid, would have been to recharacterise the £25,000 previously advanced to the Appellant as part of the consideration for the purchase. Nothing hangs on that slight complication for the purposes of this decision.

8. We also find that the remainder of the payments and transfers of assets set out in the resolution took place, except that £3,525 which was intended to be satisfied by delivery of a piece of equipment was instead settled much later in cash, pursuant to the 2008 Judgment (see [19] to [22]below).

9. Since the Appellant did not dispute that the various payments and transfers of assets were made during the 2005-06 tax year, and this would have been consistent with the terms of the 2006 Agreement, we find as a fact that they were so made (with the exception of the £3,525).

10. The Appellant made no mention of the purchase of his shares by the Company in his tax return for the year 2005-06, which he signed on 11 December 2006, or in any subsequent tax return.

The Company's accounts

(a) The October 2004 accounts

11. The Company's unaudited abbreviated statutory accounts for the year ended 31 October 2004, approved by the Board of Directors on 12 April 2005 and filed with the Registrar of Companies on 25 April 2005 (and therefore the latest formal accounts available to the directors in January 2006), showed called up share capital of £40 and accumulated profit and loss account of £47,044. The latter amount was subsequently revised (see [17] below).

12. We were not provided with a copy of the unaudited financial statements from which the 2004 statutory accounts were derived. We infer that these financial statements:

(1) had either been laid before the members in general meeting or sent to the members pursuant to section 252 Companies Act 1985 between 12 and 25 April 2005,

(2) were therefore the relevant accounts for the purposes of section 270(3) Companies Act 1985 as at 20 January 2006, and

(3) showed distributable reserves of £47,044.

(b) The October 2005 accounts

13. The Company's unaudited abbreviated statutory accounts for the year ended 31 October 2005 were signed on behalf of the Board on 27 July 2006 (six months after the Appellant's departure from the Company) and lodged with the Registrar of Companies on 4 August 2006. They showed accumulated profit and loss reserves of £51,167 as at 31 October 2005 (up by £4,123 from £47,044 the previous year).

14. The unaudited financial statements from which the abbreviated accounts were derived were also signed by the Board on 27 July 2006 and showed the Company had made a net profit for the year of £84,243 after tax. £80,120 of this profit was shown as a "final" dividend on the "A" Ordinary shares, with the remaining £4,123 of profit being carried forward as part of the accumulated profit and loss reserve. The balance sheet showed £61,754 of debts due from the directors on current account (in contrast to amounts owed to directors of £319 on 31 October 2004). Directors' salaries during the year were £11,000 (2004: £5,600). The 2005 accounts referred to the fact that the Appellant had ceased to be a director after the year end. Certain figures in these accounts were subsequently restated (see [17] below).

(c) The October 2006 accounts

15. The Company's unaudited abbreviated statutory accounts for the year ended 31 October 2006 were filed with the Registrar of Companies on 25 April 2007, having been approved by the director (Mr Thomson) on 14 March 2007.

16. The unaudited financial statements from which the abbreviated accounts were derived were also signed by the director on 14 March 2007. They recorded the Appellant's resignation on 20 January 2006, and the purchase of his shares by the Company on that date "for a total consideration of £120,000". They showed a net profit for the year after tax of £98,890, dividends of £25,000 and a debit to profit and loss account of £120,000 in respect of "purchase of own shares". They also showed the previous year's carried forward profit and loss reserve as £50,809, which was therefore reduced to £4,699 at the year end (though no comment is made concerning the fact that the October 2005 accounts showed the profit and loss reserve figure as £51,167 and not £50,809). In addition, they showed the Appellant's supposed indebtedness to the Company of £21,981 at the year end. Certain figures in these accounts were also subsequently restated (see [17] below).

(d) Subsequent restatements

17. The bundles also included copies of the Company's 2008 unaudited financial statements, apparently approved by the director on 30 July 2009. These included a prior year adjustment to reserves to reflect the fact that certain pension and life assurance premiums paid by the directors since 2004 should properly have been treated as liabilities of the Company. The effect was to reduce the accumulated distributable reserves in the 2004 accounts from £47,044 to £25,357, to reduce the accumulated distributable reserves in the 2005 accounts from £50,809 to a deficit of £832 and to reduce the accumulated distributable reserves in the 2006 accounts from

£4,699 to a deficit of £40,050 (even after the "reversal" of the £25,000 dividend originally provided in the 2006 accounts).

(e) General

18. Thus it is clear that the latest information available to the directors of the Company at January 2006 (at least in terms of proper accounts, being the October 2004 accounts) showed distributable reserves of £47,044, and even if the directors had been aware of the likely content of the October 2005 accounts, they would have known that the Company's distributable reserves shown in them would only have been £51,167. In a situation where the directors and their advisers were quite clearly ignorant of the Companies Act requirement for annual or interim accounts to be drawn up to show the requisite distributable reserves in connection with a purchase of own shares, and in the absence of any evidence as to the existence of any accounts other than the statutory annual accounts, we find as a fact that no other accounts were drawn up at the time.

The 2008 Judgment

19. The 20 January 2006 agreement ("the 2006 Agreement") did not put an end to the dispute between the Appellant and Mr Thomson.

20. It seems that there was an outstanding debt owed by the Appellant to the Company of some £21,981 as at 20 January 2006 (by way of an overdrawn director's loan account – see [16] above) and there was disagreement as to whether that debt was discharged as a result of the 2006 Agreement.

21. On the other hand, an item of equipment that was supposed to be delivered to the Appellant pursuant to the 2006 Agreement was not delivered (a lifting beam to a value of £3,000 plus VAT, totalling £3,525).

22. The Company sued the Appellant in the Gloucester County Court for payment of the allegedly outstanding £21,981 debt and the Appellant counterclaimed for the value of the beam (and consequential loss arising from its non-delivery). The hearing took place on 7 August 2008. In consequence of the 2008 Judgment, this dispute was resolved essentially in favour of the Appellant in November 2008, when the Company's claim against him was formally dismissed by the court and his counterclaim (in the sum of £3,525) succeeded.

23. It is important to note that there is no mention in the 2008 Judgment of any argument put to the County Court about the legal validity or otherwise of the 2006 Agreement under the Companies Act 1985 (the legislation in force in January 2006 which regulated purchases of own shares by a company). The court therefore reached its conclusion without reference to any such matter.

24. In passing, it is also worth mentioning that the effect of the dismissal of the Company's claim against the Appellant for £21,981 was to remove that amount as an asset in the Company's books, thus effectively reducing its distributable reserves by

that amount (quite apart from any effect it may have had under the tax provisions dealing with loans to participators).

HMRC's enquiry and the appeal

25. The circumstances in which HMRC opened an enquiry into the tax returns of the Appellant for (amongst other years) the tax year 2005-06 were not explained to us, but there was no argument that there was any procedural irregularity in the opening, conduct or closing of that enquiry. It seems the enquiry was opened on 29 May 2009 under the "discovery" provisions of section 29 Taxes Management Act 1970 ("TMA"). On 17 February 2010, HMRC issued a decision letter to the Appellant, informing him of their decision to raise an assessment in respect of, amongst other things, what they regarded as the £120,000 distribution that the Appellant had received from the Company in 2005-06.

26. On 18 March 2010 the Appellant notified his appeal to HMRC in respect of the tax on the £120,000 distribution. His grounds of appeal were that the payment was a capital distribution under section 122 Taxation of Chargeable Gains Act 1992 ("TCGA") which qualified for business asset taper relief.

27. On 11 May 2010, HMRC wrote to the Appellant's accountants, rejecting their argument that the £120,000 was a payment of capital. They referred to section 220(5) Income and Corporation Taxes Act 1988 ("ICTA") and pointed to the fact that as the Company had only been incorporated on 23 January 2002, the Appellant could not have held his shares for the relevant five year qualifying period.

28. On 16 June 2010 HMRC wrote to the Appellant and confirmed their earlier decision. This time, they informed him of his right to a formal review or to appeal the decision direct to the Tribunal.

29. On 30 July 2010, a formal review having been requested, Geldards wrote to HMRC. For the first time in this letter, the lawfulness of the purchase of own shares by the Company was raised. They said:

> "It is our view that the Agreement (and by extension the purported transfer of the consideration to Mr Baker) was unlawful and void as it was in breach of the terms of s. 164 Companies Act 1985. The reasons for this are set out in a letter before action plus enclosures dated 21 July 2010 sent to Rickerbys LLP, the solicitors for Thomson Rail, on 21 July 2010. A copy of that letter is enclosed herein for HMRC's information."

30. In their letter to Rickerbys, apart from claiming that the Company was liable to pay the Appellant's tax liability arising from the purchase, they also said the following:

> "However, it has also come to our attention that notwithstanding the above point, the settlement agreement itself was dependent upon Thomson Rail having sufficient distributable profits to purchase Mr

> Baker's shares in the company pursuant to s. 164 Companies Act 1985 concerning off market purchases.
>
> Having reviewed Thomson Rail's accounts for the financial years spanning the Agreement, it is highly likely that the distributable reserves required to allow an off market purchase under s. 164 Companies Act 1985 were not present and therefore the transaction may itself be void.
>
> Please provide us with your firm's views on this point after taking instructions from Thomson Rail and its accountants."

31. Geldards asked HMRC to delay completion of their review until a reply had been received from Rickerbys.

32. On 18 August 2010, Rickerbys replied to Geldards. They confirmed that their instructions were that:

> "1. With regard to the Settlement Agreement, we are of the view that this document was void ab initio because (inter alia): -
>
> 1.1 The Company had insufficient distributable reserves at the time of the Agreement; and
>
> 1.2 The consideration for the alleged purchase of shares was not in cash as required under the terms of the Companies Acts.
>
> 2. The unfortunate position resulting from the terms of the Settlement Agreement is that there are a number of unintended consequences: -
>
> 2.1 RB remains shareholder *[sic]* within the Company;
>
> 2.2 RB is indebted to the Company for sums paid to him in respect of his shares; and
>
> 2.3 Consideration will have to be given as to whether the tax indemnity contained in the Settlement Agreement is effective and indeed whether sums paid by the Company on behalf of RB should now be recouped from RB."

33. Geldards sent a copy of this letter to HMRC on 13 September 2010.

34. There followed further correspondence on other matters, and a number of extensions were agreed for the conclusion of HMRC's formal review. Finally, on 28 February 2011, HMRC issued their review letter. It effectively ducked the point, stating that the grounds of appeal had moved on since the Appellant's original appeal and:

> "…. [i]t is not within the remit of this review to consider the implications of the legislation contained in the Companies Acts.

> The position is that, through a mixture of cash and business assets, you have received £120,000 for your shares. The final element of this was made up when you were awarded £3,525 as the market value of the beam, which was not handed over by TREL.
>
> Whilst future action may in full or in part reverse the agreement of 20 January 2006, HMRC can only consider this when it happens. Until that agreement is struck out or amended and it can be demonstrated that the assets and cash have been returned to their original ownership there is no reason to assess any figure other than the agreed sale price."

35. HMRC therefore confirmed their decision to assess the £120,000 as a distribution under section 209(2)(b) ICTA, subject to a reduction of £20 to the amount so assessed, to reflect the repayment (as capital) of the amount originally subscribed for the shares in question.

36. The Appellant's appeal was notified to the Tribunal on 29 March 2011.

37. The Company went into administration on 1 August 2012. Up to the date of the hearing, no action had been taken by the Company to obtain the return of any part of the £120,000 from the Appellant.

The law

38. The legislative provisions relevant to the matters in dispute are section 209 ICTA, section 415 Income Tax (Trading and Other Income) Act 2005 ("ITTOIA") and the relevant provisions from the Companies Act 1985. Relevant extracts, as at 20 January 2006 (unchanged at all relevant later times), are included in Part B of the Schedule to this decision.

39. Mr Brooks also referred us to a number of cases, some of which are referred to in the summary of his submissions set out below.

Submissions of the parties

HMRC's submissions

40. Up to the submission of their skeleton argument, HMRC argued their case solely on the basis that the payments and transfers of assets made by the Company to the Appellant were distributions by virtue of section 209(2)(b) ICTA.

41. Mr Shea argued that notwithstanding any breach of company law, the transaction had still actually taken place and the "economic reality" of what had happened was that the Company had purchased its own shares from the Appellant in exchange for the cash payments and other assets transferred to him. He submitted that the tax treatment must follow the economic reality. It made no sense to conclude that the Appellant was still a shareholder and the consideration was anything other than an outright payment, given the clear intention to sever all relations.

42. He placed some weight on the observation that the transaction had not been declared void, nor had it been "unwound" by agreement, nor in the seven years since it had taken place had any party to the 2006 Agreement taken any action to test the position under company law. In the 2008 litigation no argument had been raised on the point, and indeed the Appellant had in that litigation been seeking to enforce the 2006 Agreement. He also referred to section 277 Companies Act 1985 (on the basis of which he submitted it was "reasonable to conclude" that the Appellant believed he was receiving a distribution at the relevant time).

43. He also argued that even if the purchase of own shares was technically void, the fact of the matter was that the Appellant had received £120,000 by way of a distribution out of the assets of the Company in respect of his shares in the Company. As such, it fell within the general wording of section 209(2)(b) ICTA.

44. His final argument (raised for the first time in his skeleton argument, and not pursued with any great vigour at the hearing) was that if the Appellant had been under an obligation to repay the £120,000 by reason of breaches of the Companies Act, the fact that he had not done so (and had not apparently been put under any pressure by the Company to do so) led to the inference that he had in fact received a loan or advance in his capacity as a participator in the Company, which loan or advance had subsequently been released or written off and he should therefore be liable to tax under section 415 ITTOIA.

Appellant's submissions

45. Mr Brooks argued as follows.

46. Any purchase by a company of its own shares which was not carried out in accordance with Chapter VII of Part V Companies Act 1985 (sections 159-181) was, by virtue of section 143(2) of that Act, void.

47. Because of the following three specific factors, he argued that the purchase had not been carried out in accordance with the Companies Act provisions:

(1) Payment in full had not been made on completion, as required by sections 159(3) and 162(2) Companies Act 1985;

(2) The Company had insufficient distributable reserves to permit the purchase to take place (see sections 160(1), 162(2), 181, 261(1) and (3) and 270 Companies Act 1985); and

(3) The shares could not have been validly purchased out of capital because no attempt had been made to comply with the requirements of section 173 Companies Act 1985.

48. It followed, he submitted, that the purchase of own shares by the Company on 20 January 2006 was void. This meant that, in law, the purchase never happened. The Appellant continued to own the shares and the Company was entitled to recover the £120,000 from him. He cited Lord Goff in *Kleinwort Benson Limited v Lincoln*

City Council and others [1999] 2 A.C. 349 at 389: "There is no principle of English law that money paid under a void contract is not recoverable on the ground of mistake of law because the contract was fully performed." Whatever the actual status of the amounts he had received, the Appellant had therefore received no distribution and was accordingly not subject to tax as asserted by HMRC.

49. His submissions under the three headings were developed in a little more detail as follows.

(a) Payment in full not made on completion

50. He referred us to the judgment of Sales J in *Kinlan v Crimmin* [2006] EWHC 779 (Ch). In that case, a company was owned 50:50 by two individuals and they agreed to dissolve their business relationship. The shares of the departing director were bought by the company in exchange for an immediate payment of £100,000 and an agreement for a deferred payment of £30,000 (in each case, by the company). The company had sufficient distributable reserves to make the payments.

51. Sales J referred to the combined effect of sections 143(2), 159(3) and 162(2) Companies Act 1985 as having a "dramatic" effect. The combined effect of section 159(3) and 162(2) was that "the terms of purchase must provide for payment upon acquisition (and cancellation) of the shares", and since the agreement in that case included provision for a deferred payment, section 143(2) meant that the clause of the agreement which provided for sale of the shares and the consideration payable for it (and any provisions of the wider agreement "which cannot sensibly be regarded as severable" from that provision) "must be treated as void".

52. Mr Brooks invited us to reach the same conclusion in this case, so that the purchase of own shares by the Company and the related obligation to make payments (in cash and in kind) should both be treated as void.

(b) Insufficient distributable reserves

53. Section 160(1) Companies Act 1985 (as applied to purchases of own shares by section 162(2) Companies Act 1985) stated that, in the absence of an issue of new shares for the purpose, purchases of own shares could generally only be made out of distributable profits. There was an exception for purchases made out of capital where the appropriate procedures were followed (see below).

54. "Distributable profits" were defined for this purpose in section 181(a) Companies Act 1985 to mean, in relation to any payment, profits out of which the company could lawfully make a distribution (within the meaning of section 263(2)) equal in value to the payment. It is clear that the payments, in cash and kind, to be made by the Company in this case amounted to a "distribution" within the meaning of section 263(2). The question therefore was whether, at the time of the 2006 Agreement, the Company had distributable profits at least equal to the amounts payable for the shares.

55. The amount of the available distributable profits had to be assessed, under section 270(3) Companies Act 1985, by reference to a company's latest annual accounts as laid before (or sent to) the members. In the present case, this referred to the accounts to 31 October 2004, which showed distributable reserves of £47,044, significantly less than the £120,000 in total to be paid (in cash or in kind) under the 2006 Agreement.

56. If the last annual accounts showed insufficient distributable reserves, the situation could be addressed by drawing up "interim accounts" under section 270(4) Companies Act 1985. This was never done.

57. The case of *It's a Wrap (UK) Limited (in liquidation) v Gula* [2006] EWCA Civ 544 showed the importance of a company's accounts as the reference point for assessing whether there were profits available for distribution. It was not permissible to look past the statutory requirements to rely on other evidence to suggest (however implausibly) that the Company might have had sufficient distributable reserves at 20 January 2006.

58. It followed that the purchase of own shares by the Company and the related obligation to pay the consideration for such purchase were void.

(c) No attempt to authorise payment out of capital

59. Mr Brooks pointed out that there was a statutory procedure, under sections 171-177 Companies Act 1985, for a purchase of own shares to be financed out of capital. Crucially, this process involved a statutory declaration of solvency by the Directors, supported by an auditor's certificate. Neither had been produced and therefore it was clear that no authorised purchase out of capital had taken place. This did not therefore provide a means of validating the purchase which was otherwise void under section 143(2) Companies Act 1985.

Discussion and conclusion

Preliminary points

60. We discount entirely any suggestion that the Appellant should be taxed on the basis of the "economic reality" of what has taken place. Such a submission has a degree of unreality about it, bearing in mind the approach taken by HMRC in the sad appeals from defrauded investors in complicated life insurance bonds who have lost most or all of their investment but are still being taxed by HMRC on entirely fictitious gains arising under the life policy "chargeable events" rules.

61. It seems to us to be axiomatic that the nature of a transaction and its effect for tax purposes must be determined by reference to the time when that transaction took place. Later events may illuminate history, but they cannot change it.

62. In the present case we are mainly asked to establish the true nature and tax effect of a transaction which purportedly took place on 20 January 2006. In addition, we are asked to determine the effect of some transactions (payments and transfers of

assets) which took place later but in purported satisfaction (whether voluntary or, in the case of the £3,525 paid pursuant to the 2008 Judgment, involuntary) of the obligations purportedly undertaken on 20 January 2006. There is no evidence that any of the later payments or transfers of assets were referable to anything other than the 2006 Agreement and we therefore treat them all the same for present purposes (apart from the money paid in satisfaction of the 2008 Judgment – see [88] below).

63. We take the view it is quite clear (and indeed Mr Shea did not seriously argue otherwise) that the 2006 Agreement fell foul of section 143(2) Companies Act 1985 as a result of the provision in it for deferred consideration and also as a result of the insufficiency of distributable profits (as shown by the relevant accounts). The result is that, as stated in section 143(2), "the purported acquisition is void". Following *Kinlan* at [50], this is to be interpreted as meaning that the entitlement to consideration for the purchase, not being sensibly capable of severance from the purported agreement to acquire the shares, is also void.

64. But in fact the Company made the payments (in cash and in kind) contemplated in the 2006 Agreement. £120,000 in cash or in kind has been paid over to the Appellant by the Company and retained by him. The question for our determination is whether any such payment amounted in law to a "distribution out of assets of the company in respect of shares of the company" for the purposes of section 209(2)(b) ICTA. We would emphasise that, in the present circumstances, any tax charge arising under section 209(2)(b) ICTA would arise by reference to the date or dates on which any relevant cash payment or transfer of assets actually took place and not (if different) by reference to the 20 January 2006 date of the 2006 Agreement.

65. It seems to us that in order to answer the question identified in the previous paragraph, we must identify the nature of each such payment when it was made. This is essentially a legal question. To take two extreme examples, assets transferred outright to shareholders by way of dividend in specie would clearly fall within section 209(2)(b), whereas a cash loan on normal commercial terms, or the lending or hiring out of an asset of the company would not. To put it another way, the simple act of passing cash or some tangible asset to a third party does not of itself fall within or outside section 209(2)(b) ICTA, it is the legal basis on which the cash or asset is passed over that determines the matter. Whilst the point was not raised in argument, we consider that the legal basis of the transfer would also need to be taken into account in any consideration of whether a distribution might have occurred under section 209(4) ICTA.

66. The crucial issue, therefore, is the legal effect in the present situation of the fact that the Company's acquisition of its own shares and the corresponding obligation to pay for them were both, in our view, void.

Restitution

67. In general terms, where money is paid pursuant to a mistaken belief of the existence of an obligation to pay it, the payor is entitled to recover the money by way of a claim for restitution. That was the situation in *Kleinwort Benson*, indeed the

judgement in that case records that the payments that had been wrongly made by the bank in satisfaction of its believed obligations under the void contracts were all recovered, either by agreement or by summary judgment, except for those payments where there was a potential limitation argument. It was settled in *Kleinwort Benson* that "there is no principle of English law that money paid under a void contract is not recoverable on the ground of mistake of law because the contract was fully performed."

68. Applying the same principles to the present case, when examining the position immediately following each payment and transfer of assets (other than the £3,525 paid under the 2008 Judgment), it seems to us that the Company would have had an unanswerable claim for its repayment or return.

Constructive trust

69. Section 143(1) Companies Act 1985 imposed a general prohibition on purchases of own shares by a company, subject only to "the following provisions" (i.e. compliance by the company with one or other of the permitted methods of purchasing its own shares). Any purported transaction by the directors of a company, in breach of that prohibition, in which they arrange for the company to part with its assets, amounts to a misapplication of those assets.

70. The directors of a company are, in relation to the property of the company, in the same position as trustees. They are potentially liable as such for any misapplication of the assets of the company. Where a third party, with full knowledge of facts which amount to such a misapplication (whether or not he is aware that it is in law a misapplication), receives the assets in question, then it is clear that a constructive trust arises under which the assets are, in his hands, impressed with a trust in favour of the company – see *Belmont Finance Corporation v Williams Furniture (No. 2)* [1980] 1 All ER 393 and subsequent cases.

71. In the present case, whilst there is no evidence that the Appellant knew the purchase of own shares to be a misapplication of the Company's assets, he was aware of all the details of the transaction and its surrounding circumstances and, as a matter of law, it was such a misapplication. He therefore, in our view, became a constructive trustee of the payments and other assets received by him pursuant to the purported transaction.

Initial conclusion

72. Our initial view is therefore that, whether in a claim for restitution or through the mechanism of a constructive trust (or both), the Appellant was under an obligation to repay the amounts he received pursuant to the 2006 Agreement to the Company, subject to the exception referred to at [88] below.

73. Given the existence of such an obligation, we consider it cannot be correct to say that any payment he received from the Company (in cash or in kind) was a "distribution out of the assets of the company", any more than a loan would have been.

74. However, this initial view must be tested against the apparently contrary conclusion in *Kinlan.*

Kinlan considered

75. In that case, the company (in liquidation) was seeking the repayment of the
5 amounts actually paid by it to the departing shareholder on a purchase of own shares which had not complied with the statutory requirements. Although he held the transaction to be void, Sales J also held that the money paid to the departing shareholder could not be recovered from him by the company. This was because:

(1) He had changed his position in a fundamental respect in good faith in
10 reliance upon the shared assumption that the agreement was valid; if he had realised the money was recoverable, he would have wished to consider how to protect his continuing interest in the company – either by resuming his rights as a shareholder or by seeking to reformulate the agreement on a basis that was legally valid.

15 (2) He might (Sales J put it no higher, and explicitly did not rely on this ground) have the right to set off against the company's claim a claim in *quantum meruit* for the value of his actions in stepping down from any management role in the company.

(3) Sales J would in any event have granted relief under section 727
20 Companies Act 1985, exempting the departing director from any liability in respect of the money actually received from the company.

76. In other words, in *Kinlan*, notwithstanding the fact that the payment was found to be void under section 143(2) Companies Act 1985 by reason of the "deferred payment" element, the court found that the departing shareholder was entitled to keep
25 the money he had received.

77. The basis of Sales J's decision is quite specific. He observed that the "usual principles" governing the obligation to repay (in cases of payment on the basis of a mistake of law or fact) should apply. In broad terms, this would normally mean that a repayment could be claimed (subject to issues such as limitation). However, he went
30 on to say at [58] that there were "two important and unusual features of this case" which affected matters.

78. The first was that he found as a fact that if the parties had been made aware of the point in advance, they would have changed the terms of the agreement so that the purchase price had to be paid in full on completion.

35 79. The second was that the company in that case was what he called a "quasi-partnership", in which the shareholder's rights were protected by a combination of his rights as a shareholder and his position as a director and employee of the company. When his shares were "bought", he ceased to take any active part in the affairs of the company and, in that way, he "changed his position in a fundamental respect in good

faith in reliance on his assumption (shared with Mr Smith and the company) that the agreement was valid...".

80. On the basis of these two factors, he held that the departing director/shareholder had "a good defence to the claim for repayment of monies which is now made against him."

81. He also went on to say that in the circumstances of the case, the departing shareholder/director should be given relief under section 727 Companies Act 1985, on the basis that he had "acted honestly and reasonably in all the circumstances, and ought fairly to be excused from liability in respect of the whole sum actually received".

82. Whilst Mr Rea did not specifically address this point, we take him as effectively arguing that this Appellant is in a similar position to Mr Kinlan; therefore if he has received payment from the Company for his shares and cannot be required to repay it, he must be regarded as having received a distribution falling within section 209(2)(b) ICTA.

83. The difficulty we see with this line of argument is threefold, in spite of the obvious factual parallels between *Kinlan* and the present appeal.

84. First, in *Kinlan* the only breach of the Companies Act requirements was the provision for the partially deferred consideration. The parties had been –

> "…caught out by a very technical provision of the Companies Act, in relation to a transaction which appeared to them to be a perfectly fair and appropriate bargain..."

(at [53]). In the present case, the far more material breach of the Companies Act related to the lack of distributable reserves, a matter going to the heart of the maintenance of capital rules which are in place for the protection of creditors generally. Sales J gave no indication that such a fundamental matter would have received equally generous treatment. We do not feel able to hold that it should.

85. Second, we are unable to find (as Sales J did) that if the parties had been made aware of the point in advance, they would have altered the terms of the 2006 Agreement so as to fall within the statutory rules. The main problem with this is that the maximum available distributable reserves were materially less than the minimum amount the Appellant was prepared to accept for his shares. If the parties had been made aware of the point, we do not find it possible to say how they would have reacted to it, and we certainly do not feel able to hold that the 2006 Agreement would have been recast in some masterly way that would have picked a careful route through the Companies Act provisions whilst meeting the parties' financial aspirations.

86. Finally, relief under section 727 Companies Act (replaced from 1 October 2008 by section 1157 Companies Act 2006, to substantially the same effect) could only be granted by a "court" which is hearing "proceedings for negligence, default, breach of duty or breach of trust". This Tribunal is not a court and has no jurisdiction

to grant such relief. In addition, the proceedings before this Tribunal are not of the type referred to in section 727. Unless and until a court has granted such relief, we consider section 727 (and its later replacement) to be irrelevant.

87. We therefore do not consider the Appellant would have been entitled, on the basis of the *Kinlan* decision, to retain the various cash payments and transfers of assets that he received in breach of the Companies Act prohibition. Our initial view at [73] above therefore stands. It follows that since the Appellant was, at the time of the various cash payments and transfers of assets, under an obligation to return them, they cannot have amounted to a "distribution out of assets of the company" within the meaning of section 209(2)(b) ICTA. Nor, for the same reason, would such payments and transfers have given rise to a distribution under section 209(4) ICTA – the value of any benefit received by the Appellant would have been zero, given his legal obligation to return the cash and other assets.

The effect of the 2008 Judgment

88. The £3,525 paid to the Appellant pursuant to the 2008 Judgment must be considered separately, however. By the time this sum was actually paid, following the 2008 Judgment and in satisfaction of it, it is clear that by the operation of the doctrine of *res judicata*, the Appellant was under no obligation to repay it. Any argument as to the effect of the company law prohibition should have been raised in the 2008 proceedings and the failure to raise any such arguments has no effect on the validity of the 2008 Judgment (in the absence of any late appeal to set that judgment aside).

89. As the payment, when made to the Appellant, was clearly referable to the 2006 Agreement, we consider that it would therefore have amounted to a distribution falling within section 209(2)(b) ICTA and been taxable as such. However, any such liability would have arisen in the year of payment (i.e. 2008-09 or later) and any attempt to charge it to tax in 2005-06 must fail as being premature.

Section 415 ITTOIA argument

90. We can dispose of the argument under this heading quite briefly. In recognition of the fact that a charge only arises under section 415 ITTOIA if a company "releases or writes off the whole or part" of the debt in respect of the relevant loan or advance, Mr Shea invited us to find that the Company had immediately released or written off the Appellant's debt following the payments and transfers of assets.

91. In order to maintain HMRC's assessment for the year 2005-06 (which is the assessment currently under appeal), we would have to find that such an event took place during that year. The difficulty with this is that it would fly in the face of the obvious evidence that (as we have found) the Company was quite simply ignorant of the Appellant's obligation to repay until much later – specifically, after the 2008 Judgment and possibly not until August 2010 (see [30] and [32] above). For the avoidance of doubt, we find that no release or writing off took place during the year

2005-06 that could have given rise to a charge under section 415 ITTOIA, even if all the other elements to give rise to such a charge had been in place.

92. This finding means that we do not have to enter into a detailed analysis (without the benefit of any argument from the parties) on complex issues such as:

5 (1) whether the expiry of any limitation period for proceedings to recover the assets, without such proceedings having been commenced, could be regarded as amounting to a "release" or "writing off" of any part of the Appellant's "debt" for the purposes of section 415 ITTOIA; or

(2) whether the facts outlined in this decision are capable of amounting in law
10 to a loan or an advance of money potentially falling within section 419 ICTA (which would of course be a precondition of any liability arising under section 415 ITTOIA on a later release or writing off).

Summary and conclusion

93. The purchase of own shares by the Company and the Company's associated
15 obligation to settle the consideration due under the 2006 Agreement were void by reason of the failure to comply with the Companies Act restrictions on purchase of own shares. See [63].

94. The Appellant was therefore under an obligation, as and when he received cash payments and transfers of assets pursuant to the 2006 Agreement, to return them
20 to the Company. See [72].

95. The receipt of such payments and assets was therefore not capable of amounting to a distribution under section 209 ICTA. See [73].

96. The £3,525 received by the Appellant pursuant to the 2008 Judgment was, exceptionally, cash that he was entitled to retain and therefore amounted to a
25 distribution. However, this distribution arose in 2008-09 at the earliest and not in 2005-06. See [89].

97. Any charge arising under section 415 ITTOIA could not have arisen during 2005-06. See [91].

98. The appeal must therefore be allowed. This may not be the end of the matter
30 for the Appellant, however, as we are not required in this appeal to determine the validity of any later assessment which might (subject to applicable time limits) be raised in respect of matters arising in later years.

Costs

99. An application for an award of costs was made on behalf of the Appellant.

35 100. This appeal was allocated to the standard category and therefore an order for costs could only be made if we considered HMRC had acted "unreasonably in....

defending or conducting the proceedings." See rule 10(1)(b) of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009.

101. Mr Brooks submitted that HMRC, "by their total failure to recognise or accept the application of the relevant provisions of the Companies Act 1985 to the facts of this case, have acted unreasonably in defending the proceedings."

102. We disagree. The fact that the Appellant has succeeded in his appeal does not, of itself, mean that HMRC acted unreasonably in defending it. If their case had been clearly hopeless from the start then we would have been more sympathetic. But in our view it was not, as is amply demonstrated by the length and content of this decision.

103. We therefore refuse the application for costs.

104. 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.

KEVIN POOLE
TRIBUNAL JUDGE

RELEASE DATE: 17 July 2013

SCHEDULE

Part A - Terms of resolution passed on 20 January 2006

IT WAS RESOLVED that the "A" and "B" Ordinary shares held by Mr R S S Baker on 20th January 2006 would be purchased back by the Company at total value of £120,000. This amount has been calculated as follows:-

1)	A one off cheque payment has been made by the Company to Mr RSS Baker prior to 20th January 2006	£25,000
2)	Within three months of this meeting, the Company will provide Mr R S S Baker with the following equipment at a value of £46,300 plus VAT:- 1 x Mk3a Fastclip Machine 2 x Universal Lifting Beams 5 x Cable Laying Devices 1 x Rail Lifting Beam	£54,402.50
3)	The Company will settle Mr R S S Baker's outstanding tax liability relating to the 2002/03, 2003/04. 2004/05 and 2005/06 up to the date Mr R S S Baker left the company as calculated by the company's accountants B&P Accounting. This is made up as follows:-	
	Liability up to 2003/04	£11,642.65
	2004/05	£2,146.15
	2005/06	£2,553.25
	Anticipated interest and charges on 2004/05 liability	£250
4)	Mr R S S Baker will be entitled to the assets held at Newnham's Yard, which are valued at £20,000 plus VAT	£23,500.00
5)	Mr R S S Baker will receive a quantity of tools, a workbench and a portable welding set valued at £430.17 plus VAT	£505.45
	TOTAL	**£120,000.00**

The secretary was instructed to file forms 169's, together with the appropriate stamp duty, to the Inland Revenue and Registrar of Companies in respect of the aforementioned purchase of shares.

Part B – Extracts from ICTA, ITTOIA and Companies Act 1985

Section 209 ICTA

209 Meaning of "distribution"

(1) The following provisions of this Chapter, together with section 418 shall, subject to any express exceptions, have effect with respect to the meaning of "distribution" and for determining the persons to whom certain distributions are to be treated as made…..

(2) In the Corporation Tax Acts "distribution", in relation to any company, means –

(a) any dividend paid by the company, including a capital dividend;

(b) ..... any other distribution out of assets of the company (whether in cash or otherwise) in respect of shares in the company, except so much of the distribution, if any, as represents repayment of capital on the shares or is, when it is made, equal in amount or value to any new consideration received by the company for the distribution….

.....

(4) Where on a transfer of assets or liabilities by a company to its members or to a company by its members, the amount or value of the benefit received by a member (taken according to its market value) exceeds the amount of value (so taken) of any new consideration given by him, the company shall..... be treated as making a distribution to him of an amount equal to the difference.

Section 415 ITTOIA

415 Charge to tax under Chapter 6

(1) Income tax is charged if –

(a) a company is or has been assessed or is liable to be assessed under section 419 of ICTA (loans to participators in close companies, etc) in respect of a loan or advance, and

(b) the company releases or writes off the whole or part of the debt in respect of the loan or advance.

Companies Act 1985

143 – General rule against company acquiring own shares.

(1) Subject to the following provisions, a company limited by shares or limited by guarantee and having a share capital shall not acquire its own shares, whether by purchase, subscription or otherwise.

(2) If a company purports to act in contravention of this section, the company is liable to a fine, and every officer of the company who is in default is liable to imprisonment or a fine, or both; and....... the purported acquisition is void.

.....

(3) ..... subsection (1) does not apply in relation to –

(a) the redemption or purchase of shares in accordance with Chapter VII of this Part....

.....

159 – Power to issue redeemable shares.

(1) Subject to the provisions of this Chapter, a company limited by shares or limited by guarantee and having a share capital may, if authorised to do so by its articles, issue shares which are to be redeemed or are liable to redeemed at the option of the company or the shareholder.

.....

(3) Redeemable shares may not be redeemed unless they are fully paid; and the terms of redemption must provide for payment on redemption.

160 – Financing etc. of redemption.

(1) Subject to the next subsection and to sections 171 (private companies redeeming or purchasing own shares out of capital) and 178(4) (terms of redemption or purchase enforceable in a winding up) –

(a) redeemable shares may only be redeemed out of distributable profits of the company or out of the proceeds of a fresh issue of shares made for the purposes of the redemption; and

(b) any premium payable on redemption must be paid out of distributable profits of the company.

.....

(3) Subject to the following provisions of his Chapter, redemption of shares may be effected on such terms and in such manner as may be provided by the company's articles.

.....

162 – Power of company to purchase own shares.

(1) Subject to the following provisions of this Chapter, a company limited by shares or limited by guarantee and having a share capital may, if authorised to do so by its articles, purchase its own shares (including any redeemable shares).

(2) Sections 159 and 160 apply to the purchase by a company under this section of its own shares as they apply to the redemption of redeemable shares.

That is subject to subsections (2A) and (2B).

(2A) The terms and manner of a purchase under this section need not be determined by the articles as required by section 160(3).

.....

164 – Authority for off-market purchase.

(1) A company may only make an off-market purchase of its own shares in pursuance of a contract approved in advance in accordance with this section or under section 165 below.

(2) The terms of the proposed contract must be authorised by a special resolution of the company before the contract is entered into; and the following subsections apply with respect to that authority and to resolutions conferring it.

.....

(6) Such a resolution is not effective for the purposes of this section unless (if the proposed contract is in writing) a copy of the contract or (if not) a written memorandum of its terms is available for inspection by members of the company both –

(a) at the company's registered office for not less than 15 days ending with the date of the meeting at which the resolution is passed, and

(b) at the meeting itself.

A memorandum of contract terms so made available must include the names of any members holding shares to which the contract relates; and a copy of the contract so

made available must have annexed to it a written memorandum specifying any such names which do not appear in the contract itself.

.....

5

171 – Power of private companies to redeem or purchase own shares out of capital.

(1) Subject to the following provisions of this Chapter, a private company limited by shares or limited by guarantee and having a share capital may, if so authorised by
10 its articles, make a payment in respect of the redemption or purchase under section 160 or (as the case may be) section 162, of its own shares otherwise than out of its distributable profits or the proceeds of a fresh issue of shares.

(2) References below in this Chapter to payment out of capital are (subject to subsection (6)) to any payment so made, whether or not it would be regarded apart
15 from this section as a payment out of capital.

(3) The payment which may (if authorised in accordance with the following provisions of this Chapter) be made by a company out of capital in respect of the redemption or purchase of its own shares is such an amount as, taken together with—

(a) any available profits of the company, and

20 (b) the proceeds of any fresh issue of shares made for the purposes of the redemption or purchase,

is equal to the price of redemption or purchase; and the payment permissible under this subsection is referred to below in this Chapter as the permissible capital payment for the shares.

25 .....

172 – Availability of profits for purposes of s. 171.

(1) The reference in section 171(3)(a) to available profits of the company is to the company's profits which are available for distribution (within the meaning of Part
30 VIII); but the question whether a company has any profits so available and the amount of any such profits are to be determined for purposes of that section in accordance with the following subsections, instead of sections 270 to 275 in that Part.

(2) Subject to the next subsection, that question is to be determined by reference to the following items as stated in the relevant accounts for determining the permissible
35 capital payments for shares.....

.....

(3) The relevant accounts for this purpose are such accounts, prepared as at any date within the period for determining the amount of the permissible capital payment, as

are necessary to enable a reasonable judgment to be made as to the amounts of any of the items mentioned in subsection (2)(a) to (c) above.

.....

(6) References in this section to the period for determining the amount of the permissible capital payment for shares are to the period of 3 months ending with the date on which the statutory declaration of the directors purporting to specify the amount of that payment is made in accordance with subsection (3) of the section next following.

.....

173 – Conditions for payment out of capital.

(1) Subject to any order of the court under section 177, a payment out of capital by a private company for the redemption or purchase of its own shares is not lawful unless the requirements of this and the next two sections are satisfied.

(2) The payment out of capital must be approved by a special resolution of the company.

(3) The company's directors must make a statutory declaration specifying the amount of the permissible capital payment for the shares in question and stating that, having made full inquiry into the affairs and prospects of the company, they have formed the opinion—

(a) as regards its initial situation immediately following the date on which the payment out of capital is proposed to be made, that there will be no grounds on which the company could then be found unable to pay its debts, and

(b) as regards its prospects for the year immediately following that date, that, having regard to their intentions with respect to the management of the company's business during that year and to the amount and character of the financial resources which will in their view be available to the company during that year, the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due) throughout that year.

(4) In forming their opinion for purposes of subsection (3)(a), the directors shall take into account the same liabilities (including prospective and contingent liabilities) as would be relevant under section 122 of the Insolvency Act (winding up by the court) to the question whether a company is unable to pay its debts.

(5) The directors' statutory declaration must be in the prescribed form and contain such information with respect to the nature of the company's business as may be prescribed, and must in addition have annexed to it a report addressed to the directors by the company's auditors stating that –

(a) they have inquired into the company's state of affairs; and

(b) the amount specified in the declaration as the permissible capital payment for the shares in question is in their view properly determined in accordance with sections 171 and 172; and

(c) they are not aware of anything to indicate that the opinion expressed by the directors in the declaration as to any of the matters mentioned in subsection (3) is unreasonable in all the circumstances.

.....

181 – Definitions for Chapter VII.

In this Chapter –

(a) "distributable profits", in relation to the making of any payment by a company, means those profits out of which it could lawfully make a distribution (within the meaning given by section 263(2)) equal in value to the payment, and

(b) "permissible capital payment" means the payment permitted by section 171;

and references to payment out of capital are to be construed in accordance with section 171.

......

263 – Certain distributions prohibited.

(1) A company shall not make a distribution except out of profits available for the purpose.

(2) In this Part, "distribution" means every description of distribution of a company's assets to its members, whether in cash or otherwise, except distribution by way of –

(a) an issue of shares as fully or partly paid bonus shares,

(b) the redemption or purchase of any of the company's own shares out of capital (including the proceeds of any fresh issue of shares) or out of unrealised profits in accordance with Chapter VII of Part V,

(c) the reduction of share capital by extinguishing or reducing the liability of any of the members on any of the company's shares in respect of share capital not paid up, or by paying off paid up share capital, and

(d) a distribution of assets to members of the company on its winding up.

(3) For purposes of this Part, a company's profits available for distribution are its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.

.....

270 – Distribution to be justified by reference to company's accounts.

(1) This section and sections 271 to 276 below are for determining the question whether a distribution may be made by a company without contravening sections 263, 264 or 265.

5 (2) The amount of a distribution which may be made is determined by reference to the following items as stated in the company's accounts –

.....

(3) Except in a case falling within the next subsection, the company's accounts which are relevant for this purpose are its last annual accounts, that is to say those 10 prepared under Part VII which were laid in respect of the last preceding accounting reference period in respect of which accounts so prepared were laid; and for this purpose accounts are laid if section 241 (1) has been complied with in relation to them.

(4) In the following two cases –

15 (a) where the distribution would be found to contravene the relevant section if reference were made only to the company's last annual accounts, or

(b) where the distribution is proposed to be declared during the company's first accounting reference period, or before any accounts are laid in respect of that period,

20 the accounts relevant under this section (called "interim accounts" in the first case, and "initial accounts" in the second) are those necessary to enable a reasonable judgment to be made as to the amounts of the items mentioned in subsection (2) above.

(5) The relevant section is treated as contravened in the case of a distribution unless 25 the statutory requirements about the relevant accounts (that is, the requirements of this and the following three sections, as and where applicable) are complied with in relation to that distribution.

727 – Power of court to grant relief in certain cases.

(1) If in any proceedings for negligence, default, breach of duty or breach of trust 30 against an officer of a company or a person employed by a company as auditor (whether he is or is not an officer of the company) it appears to the court hearing the case that that officer or person is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with 35 his appointment) he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as it thinks fit.

(2) If any such officer or person as above-mentioned has reason to apprehend that any claim will or might be made against him in respect of any negligence, default,

breach of duty or breach of trust, he may apply to the court for relief; and the court on the application has the same power to relieve him as under this section it would have had if it had been a court before which proceedings against that person for negligence, default, breach of duty or breach of trust had been brought.

5 (3) Where a case to which subsection (1) applies is being tried by a judge with a jury, the judge, after hearing the evidence, may, if he is satisfied that the defendant or defender ought in pursuance of that subsection to be relieved either in whole or in part from the liability sought to be enforced against him, withdraw the case in whole or in part from the jury and forthwith direct judgment to be entered for the defendant or
10 defender on such terms as to costs or otherwise as the judge may think proper.