

**Judgment 32/2005 – Administrator of Income Tax v. Broadaker Company Limited – Royal Court (Civil action file 944) – 3 June, 2005**

---

**Income Tax (Guernsey) Law, 1975 – whether abortive capital expenditure could be reclassified as a bad debt – Tax Tribunal held it was an allowable deduction – Administrator’s appeal by way of case stated – appeal allowed.**

**IN THE ROYAL COURT OF THE ISLAND OF GUERNSEY**

The 3rd day of June, 2005 before Sir de Vic Carey, Bailiff; sitting alone.

In the matter of

Between:

THE ADMINISTRATOR OF INCOME TAX

Appellant

v.

BROADAKER COMPANY LIMITED

Respondent

Whereas on the 13<sup>th</sup> and 14<sup>th</sup> April, 2005, the Bailiff considered an appeal against the determination of the Guernsey Tax Tribunal dated the 13<sup>th</sup> day of October, 2003 and heard thereon Advocates R. McMahon and P. T. R. Ferbrache, Counsel for the Appellant and Respondent respectively, and whereas on the 29<sup>th</sup> day of April, 2005 the Bailiff handed down judgment in the terms attached hereto, and allowed the appeal, the Bailiff, this day, Awarded the Appellant half of his costs.

S. M. D. ROSS  
Her Majesty’s Deputy Greffier

Approved Text

**IN THE ROYAL COURT OF GUERNSEY  
ORDINARY DIVISION**

**Between:**

**THE ADMINISTRATOR OF INCOME TAX**

**Appellant**

**v.**

**BROADAKER COMPANY LIMITED**

**Respondent**

**JUDGMENT OF THE BAILIFF ON THE APPEAL AGAINST THE DETERMINATION  
OF THE GUERNSEY TAX TRIBUNAL DATED 13<sup>TH</sup> OCTOBER, 2003.**

Advocate for the Appellant: R. J. McMahon

Advocate for the Respondent: P. T. R. Ferbrache

Dates of Hearing: 13<sup>th</sup> and 14th April, 2005

Date judgment to be handed down: 29th April, 2005

The Law

1. The Income Tax (Guernsey) Law, 1975, as amended, provides in section 80 the machinery for appealing against decisions of the Guernsey Tax Tribunal on points of law. A party aggrieved with a decision of the Tax Tribunal can ask for it to produce a case stated when it has been prepared is transmitted to H.M. Greffier. Section 80(6) goes on to provide

"(6) The Royal Court sitting as an Ordinary Court shall hear and determine any question of law arising on the case, and may reverse, affirm, or amend the determination of the Guernsey Tax Tribunal, remit the matter to the Guernsey Tax Tribunal with the opinion of the Court thereon, or make such other order as the Court may think fit."

Agreed Background facts

2. The Respondent has carried on an engineering and manufacturing business in Guernsey since 1976. Its accounts for the year ended on the 31<sup>st</sup> January, 1996, were submitted in 1998. The trading and profit and loss account showed a deduction for bad and doubtful debts, which included a sum of £56,371, paid to Weldman Systems Limited ("Weldman"). The Administrator subsequently disallowed this claim as a deduction against the Company's income for the relevant period. The Respondent appealed to the

Tribunal where it was successful. The Administrator has now appealed that decision to this Court.

#### The Respondent's dealings with Weldman

3. The Respondent manufactured ceiling supports for television and audio systems. In 1994 it decided to install an integrated robotic welding system and approached Weldman in that regard. In January 1995 it made a down payment to Weldman of £56,371 ("the payment in issue") as a down payment under a contract which had been negotiated between the Respondent and Weldman in the sum of approximately double that sum. In the accounts for the year ended 31<sup>st</sup> January, 1995 – the Respondent's accounting year ended on 31<sup>st</sup> January – this payment was shown as a capital payment. There is no dispute that had the machinery been installed as envisaged the monies expended on it would have been treated as capital payments and then subject to capital allowances under section 88 of the Law of 1975. During the course of 1995 the equipment was manufactured, but it did not prove to be fit for its purpose and the Respondent rejected it.
4. By the autumn of 1995 it became evident that the problems over the unsuitability of the equipment for the purpose required had come to a head and on the 23<sup>rd</sup> October Advocate Ferbrache wrote to Weldman on behalf of the Respondent saying that the delays that had occurred and the unsuitability of the product for its purpose led to his client proposing that the payment in issue be returned and that the goods that had been manufactured would be kept by Weldman without either side having any claim against the other. By the year end there has been no return of the deposit or attempt to fulfil the contract. After the year-end it transpired that in February 1996 Weldman ceased operations. The Respondent then put good money into trying to recover the money that was owed by Weldman but without success. A receiver was appointed, but no money was identified with which the Respondent could be paid.

#### The Accounts for 1996

5. The accounts for the year ended 31<sup>st</sup> January, 1996, were not in fact produced until 1998, but nothing turns on this. When the accounts were prepared, however, they showed under the heading of tangible fixed assets what was termed a reclassification whereby the payment in issue was taken out of the plant and machinery heading of the company's tangible fixed assets and shown instead as a bad or doubtful debt (along with other bad and doubtful debts which are not disputed) resulting in the gross sum for bad and doubtful debts for the year in question being shown as £84,621.

### The Administrator's reaction

6. The papers before the Tribunal included a considerable amount of correspondence both between Weldman and the Respondent and between the Respondent and the Administrator. I need not review very much of this. However the simple and consistent answer of the Administrator to the claim of the Respondent was that the payment in issue made to Weldman could not be reclassified and set against the Respondent's income as a business expense. Accordingly it had to be disallowed in assessing the Respondent company's profits for the year ended 31<sup>st</sup> January, 1996.

### The Appeal to the Tax Tribunal

7. The Respondent being dissatisfied with the Administrator's decision to disallow the payment in issue appealed to the Guernsey Tax Tribunal who met to determine the appeal on 13<sup>th</sup> October, 2003. Later that day the Tribunal announced that it would allow the appeal and provide a written decision later, which decision was handed down on the 12<sup>th</sup> November, 2003. The Administrator being dissatisfied with that decision after a case stated which was delivered to Crown Advocate McMahon on the 17<sup>th</sup> June, 2004.
8. The Case Stated recorded the documentation that the Tribunal had before it. It went on to record the evidence of Mr. Whitaker concerning the circumstances of the making of the payment in issue and in particular recorded that Mr. Whitaker had stated that the payment in issue was originally regarded as a fixed asset but was later reclassified as a bad debt and written off. Advocate Peter Ferbrache who appeared before me also appeared before the Tribunal and his arguments are clearly summarised at page 4 of the Case Stated. The flavour of his approach can be gained by paragraph 8

"Advocate Ferbrache argued that the interpretation of Guernsey tax legislation was a matter of ordinary common sense. It was restrictive legislation and was not to be construed in favour of the Administrator."

9. Again at paragraphs 11 and 12 the arguments recorded are somewhat simplistic and not really helping the Tribunal get to the bottom of what may at first sight have appeared a somewhat unusual and difficult point. The Administrator through his Counsel Advocate McMahon made submissions. The Administrator took a view which the Tribunal found somewhat unattractive and which I too find unattractive namely that the debt had not become bad prior to the 31<sup>st</sup> January, 1996, so that there was to start with no debt to include in the 1996 accounts. Indeed if paragraph 16 of the case stated is correct it seems that Advocate McMahon was relying solely on this somewhat theoretical point, namely

that one could not say that at the end of the accounting year, 31<sup>st</sup> January, 1996, that the taxpayer was not going to be able to recover the payment in issue from Weldman.

10. It is a fact of life that any trader gives credit and inevitably he will find that some of those to whom he gives credit cannot pay him. The tax regime is such that reasonable provision must be allowed for bad or doubtful debts. Any trader will be attracted to over providing for doubtful debts on the basis that it reduces his current tax liability. The revenue must be vigilant to see that such provision is kept within bounds as it is not always satisfactory to rely on balancing charges in subsequent years to claw back any over provision. However with most trading companies these issues should not detain specialist tax inspectors for long. However in this case a great deal of argument seems to have centred around whether or not at the end of January 1996 the taxpayer was correct in taking a broad brush view that the deal with Weldman was dead and the payment in issue would be irrecoverable.
  
11. I accept Mr. McMahon's argument that there was some glow in the ashes to the extent that as I have recorded the Respondent chose to proceed against Weldman in England to see if they could recover the money that was due to it, but I fully accept the findings of fact of the Tax Tribunal (indeed as I am obliged to do so under the section of the Law to which I have referred) that the debt was to be treated as bad at the end of January 1996. As I have said this issue seems to have taken up a major part of the Tribunal's deliberations and may well have led them into a degree of confusion. Mr. McMahon when pressed to come forward with other arguments, appears to have gone on to develop the point that the Administrator would say that the payment in issue was capital expenditure and not in any event to be set against income. There is then an acknowledgment by Mr. McMahon that the Law may be defective in that it makes no provision for treatment of abortive capital expenditure.

#### Findings of the Tribunal

12. The Tribunal found at paragraph 26 that from the accounts it was apparent to it that the payment in issue had been reclassified from being a tangible fixed asset as at 31<sup>st</sup> January, 1995, to a status of a bad or doubtful debt. The Tribunal went on to say it accepted the evidence of Mr. Whitaker as to the non-delivery of the equipment and the failure to repay the amount advanced. There can be no argument as to that being correct. The Tribunal, at paragraph 30, found as fact that the debt was discovered prior to the 31<sup>st</sup> January, 1996, to be bad or recoverable and was therefore properly shown in the accounts for the

accounting period 31<sup>st</sup> January, 1996, notwithstanding that the accounts were prepared somewhat late.

13. In paragraph 31 the Tribunal found as a fact that the payment in issue was an allowable deduction section 7(3)(e) of the Law on the basis that it was a bad or doubtful debt. It then goes on to find other ways of responding to Mr. McMahon's argument if it were correct. I need not deal with these points. Again it was trying to overcome the argument of Mr. McMahon that the debt could not be treated as bad or doubtful at the end of January 1996, an argument which had failed on the Tribunal's factual finding that it had actually become bad or irrecoverable by that date.

The questions for the determination of this Court

14. I take these from the last page of the case stated. They are three in number:-

- "1. Whether the Tribunal was correct in law in concluding that there was any debt owed to Broadaker and/or that the debt was bad and doubtful within section 7(3)(e) of the Income Tax (Guernsey) Law, 1975, as amended, in the accounting period that was the subject of the appeal; or, alternatively
2. Whether the factual findings of the Tribunal in relation to those matters were supported by the evidence that was before it; and
3. Whether the Tribunal could in law or on the facts conclude that a debt arising out of abortive capital expenditure could be claimed as a permissible deduction against profits."

The arguments of the Appellant before me

15. Mr. McMahon presented his case on the basis that the appeal should be allowed on any one or more of the alternative grounds

- "(a) the Guernsey Tax Tribunal fell into error in concluding that Weldman Systems Limited ("Weldman") owed a debt of £56,371 to the Respondent taxpayer as at 31<sup>st</sup> January, 1996 (see paragraph 27 of Case Stated) because, by that date, no such debt existed and the Respondent was not a creditor of Weldman; or
- (b) even if a debt in that sum did by that date exist, there was no material before the Tribunal establishing that the debt had become bad or irrecoverable in the full amount claimed in the relevant accounting period (see paragraph 30 of Case Stated); or
- (c) in any event, the amount claimed represented abortive capital expenditure for which no deduction under section 7 of the Income Tax (Guernsey) Law, 1975, as amended, is permitted."

The Respondent's arguments before me

16. Again Mr. Ferbrache gave considerable attention in his skeleton to whether by the 31<sup>st</sup> January, 1996, the payment in issue had become a debt due to the Respondent. He also dealt with responding to the argument of the Administrator that the payment in issue even it was a bad debt could not be allowed against the income of the Respondent because it was in the nature of a capital payment rather than a revenue expense. He then sought to distance English learning from Guernsey on the basis the legislative framework was different. He also sought comfort in section 7(3)(i) which is dealing with a separate area of allowance namely allowance in respect of repairs and renovations to real property where the proviso clearly states that the allowance is not available for what are deemed to be improvements of a capital nature.

The conclusions of this Court

17. On rereading the case stated it is clear to me that the Tribunal got led into error by not separating out the two issues in this case and in this regard they may not have had the assistance from Counsel to which in retrospect they were really entitled.

Mr. McMahon's arguments (a) and (b)

18. Before me Mr. McMahon was still arguing that the entitlement of the Respondent to receive back from Weldman the monies it had paid by way of deposit for welding equipment which clearly had not been delivered by the end of the accounting period and on any view was not going to be delivered was not a debt due on 31<sup>st</sup> January, 1996, to the Respondent. The Tribunal in my view rightly took the view and found as a fact that the only conclusion that could be properly drawn was that the end of January 1996 the monies were irrecoverable. That is a finding of fact, which as I have said I cannot in any event go behind.

Mr. McMahon's argument (c)

19. What I can go behind is the gloss on this finding that the payment in issue, without more, became allowable against the company's income for the year in question. To reach a conclusion on this we have to consider Mr. McMahon's third submission namely that the payment in issue was essentially a capital payment as indeed it had been regarded when the accounts for the year ended 31<sup>st</sup> January, 1995, were prepared. It does not follow that because a company pays out money by way of advance to another party for what is an item of capital expenditure and it is subsequently found that, as here, the third-party fails

to deliver the item or otherwise proves to have been abortive, the payment is in some way converted to being allowable against income. The original payment thus does not automatically become convertible into revenue expenditure when there has been unforeseen depreciation or loss of this kind. Bad debts are not defined as being trade debts, but in order to be allowable against the profits of the company they must be debts incurred as part of the business activity of the company. There is one case which provides for some authority for this namely Curtis v. Oldfield 1923 – 1925 9 TC 319. There the managing director of the taxpayer company had died. After his death it was shown that many payments and some receipts not relating to the company's business, but to his private affairs had been passed through the company's books resulting in a deficit due from his estate in the sum of £14,000. The estate was insolvent and the debt was valueless and it was written off in the books of the company.

20. I accept the point made by Mr. Ferbrache that this decision was based on English Rules, but since the hearing I have received from Mr. McMahon a copy of the Law in place in England at the time and I am satisfied that the principles to be applied are the same.

21. Mr. Justice Rowlatt summarised the position in Curtis v. Oldfield as follows:-

"When the Rule speaks of a bad debt it means a debt which is a debt that would have come into the balance sheet as a trading debt in the trade that is in question and that it is bad. It does not really mean any bad debt which, when it was a good debt, would not have come in to swell the profits. What the Commissioners have been misled by, in my judgment, quite clearly is this. They have allowed themselves to act under the impression that they were taxing the Company on what the Company in a loose way had made and secured. In point of law they were engaged in assessing the profits of the Company's trade, not of the Company itself but of the Company's trade, and I have to consider whether there is the least ground for supposing that losses of these sums resulting in this bad debt were losses in the trade."

22. A similar point arose in English Crown Spelter Co. Ltd. v. Baker 1908 5 TC 327 where a company engaged in the business of zinc smelting decided not to directly invest in certain new mining concessions, the exploitation of which would provide necessary raw material ("blende") for its business, but to arrange for a separate company to be formed for those purposes. The new company was lent money to assist it in establishing itself. It failed and the money became irrecoverable. It was held by the Court that these loans were capital payments and were not something that could be deducted by the smelting company for income tax purposes.

23. At the end of the day the issue here is quite simple. It was not whether or not the liability in respect of the payment in issue had crystallised by the end of the January 1996 accounting period, but whether that liability could properly be treated as a debt incurred

as part of the trading operation of the taxpayer and was therefore allowable against the trading profits of the taxpayer when it was deemed to be bad. In my judgment the position is clear albeit that it results on first examination in some harsh consequences for the taxpayer. The deposit paid in respect of the new capital equipment was a capital payment. It cannot be spirited into being an income payment simply because the project is aborted and the Respondent taxpayer must in my view bear tax on its profits for the year of charge 1997 based on its accounts for the year ending 31<sup>st</sup> January, 1996, on the basis that it cannot set aside against those profits the money abortively expended as a deposit on the new welding equipment. It appears that this issue may have been addressed in England, which has a somewhat similar tax regime to Guernsey, albeit that it also seeks to levy taxation on capital as well as income, but the introduction of any relief for abortive capital expenditure in Guernsey is a matter for the legislature and not for the Courts. This appeal must be allowed and when it is handed down I will consider issues relating to any applications for costs.