Judgement 4/2006 Administrator of Income Tax v Cachemar Limited –Court of Appeal (Civil Appeal 361) - 31st January, 2006

Income Tax (Guernsey) Law 1975 – whether "investment management fees" are deductible as permissible management expenses – Administrator's appeal from the Tax Tribunal to the Royal Court dismissed (see Judgment 35/2005) – Administrator's further appeal dismissed

IN THE COURT OF APPEAL OF GUERNSEY

The 31st day of January, 2006 before, Peter David Smith Esq., QC, presiding, Kenneth Stuart Rokison Esq., QC and Dame Heather Steel, DBE

ADMINISTRATOR OF INCOME TAX

('The Administrator')

v

CACHEMAR LIMITED

('The Taxpayer')

In the appeal by the Administrator from the dismissal by the Royal Court on 13th June, 2005 of the appeal by the Administrator from the decision of the Guernsey Tax Tribunal dated 8th June, 2004;

WHEREAS, on 15th December, 2005, THE COURT, having heard Advocate R. J. McMahon for the Administrator and Advocate P. T. R. Ferbrache for the Taxpayer thereon, DISMISSED the appeal and reserved its reasons, and Counsel for the Taxpayer indicated that no application would be made as to costs;

THE COURT this day ISSUED Judgment in the attached terms.

K. H. TOUGH
Registrar of the Court of Appeal

Approved Text
31.1.06

31st JANUARY, 2006

COURT OF APPEAL

Before

Peter David Smith Esquire QC
Kenneth Stuart Rokison Esquire QC
Dame Heather Steel

THE ADMINISTRATOR OF INCOME TAX

-v-

CACHEMAR LIMITED

Introduction

1. This appeal arises out of a decision of the Guernsey Tax Tribunal ("the Tribunal") handed down on 8 June 2004. That decision concerned an appeal by Cachemar Limited, the Respondent to this appeal ("the Taxpayer") against the refusal of the Administrator of Income Tax, the Appellant in this appeal, ("the Administrator") to allow a deduction from its income. The Tribunal found in favour of the Taxpayer and the Administrator, being dissatisfied by that determination as being erroneous in point of law, required the Tribunal to state and sign a case for submission to the Royal Court in accordance with section 80 of the Income Tax (Guernsey) Law 1975 ("the Law"). The question of law arising on the case was heard and determined in the Royal Court by Mr. Patrick John Talbot QC, Lieutenant Bailiff. He found in favour of the Taxpayer and the Administrator has appealed to the Court. Having heard the arguments of both sides, advanced by Crown Advocate R J McMahon for the Administrator and Advocate P T R Ferbrache for the Taxpayer (to both of whom we are indebted), we indicated that he had decided to dismiss this appeal and that we would give our reasons at a later date. This we now do, and this is the judgment of the Court.

The Relevant Statutory Provisions

2. It is not disputed that the Taxpayer is an "investment company" within the meaning of section 169 of the Law. In so far as material, that section defines an investment company as "a company which is resident in Guernsey … and whose activities consist wholly or mainly in the making of investments and the principal part of whose income is derived therefrom."

3. Section 2 of the Law describes the four classes of income in respect of which tax is chargeable. These are:

> "(1) income from businesses;
>
> (2) income from offices and employments;
>
> (3) income from the ownership of lands and buildings; and
>
> (4) income from other sources."

4. Section 7 deals with the computation of the amount of the profits of any business (i.e., class (1) of section 2 of the Law) and subsection (1) of that section provides that they "shall be computed in accordance with the ordinary commercial principles applicable to the computation of profits of that business." Section 8 of the Law deals with income from offices and employments (i.e., class (2) of section 2) and sections 6 - 16 inclusive of the Law deal with the assessment of income arising from the ownership of lands and buildings (i.e., class (3) of section 2). Of these, only section 13 has any bearing on this appeal and we set out the relevant subsection at a later stage in this judgment when we come to consider it.

5. Section 17 of the Law, which deals with income from other sources (i.e., class (4) of section 2) is relevant and the material part of subsection (1) reads as follows:

> "The assessable income from sources not covered by any of sections seven, eight or nine of this Law shall be the income arising or accruing from such sources after deduction of any expenditure not being:
>
> … (b) in the nature of capital expenditure or personal expenses
>
> wholly and exclusively incurred for the purpose of earning such income."

6. Part XIV of the Law contains what are described as "Special Provisions as to Investment Companies Resident in Guernsey and to Unit Trust Schemes." Section 160 reads:

> "For the avoidance of doubt is hereby declared that, subject as hereinafter provided in relation to the expenses of management of investment companies, the assessable

> income arising or accruing to an investment company from the ownership of any land and any building situate in Guernsey shall be determined in accordance with the provisions of sections nine to sixteen of this Law, and the assessable income arising or accruing from any other investment shall be determined in accordance with the provisions of section seventeen of this Law."

7. Section 162 of the Law provides that a deduction from the income arising or accruing to an investment company for any year of charge may be permitted by the Administrator in respect of sums disbursed as "permissible management expenses" in the year of computation if a claim has been made in compliance with the section. In section 169 of the Law the phrase "permissible management expenses" in the case of an investment company is defined as meaning:

> "… such items of expenditure as are laid out or expended wholly and exclusively for the purpose of managing the company as would be permissible deductions in accordance with such provisions of this Law as relate to the computation of the profits of a business if the profits of the company fell to be computed in accordance with those provisions, but does not include:-
>
> (a) any item of expenditure which may be deducted or taken into account under any provision of this Law which does not relate specifically to expenses of management, or
>
> (b) any expense of management which may be taken into account for the purpose of determining the amount of any additional deduction which may be claimable under the provisions of section thirteen of this Law."

8. Section 18 of the Law provides that the onus of proof that any expenditure is an allowable deduction from profits or income for the purpose of the Law shall be upon the person claiming so to deduct.

The Taxpayer's Claim

9. The Taxpayer claimed to be entitled to deduct as permissible management expenses within the meaning of section 169 of the Law "investment management fees" totalling £14,944 which it had paid during the year of charge to an Isle of Man company on foot of a written "Investment Management Agreement" ("the Agreement"). Under it the Isle of Man company managed the portfolio of assets (including uninvested cash) entrusted to it by the Taxpayer (described as "the Fund") and its management fee (singular in the Agreement) was calculable, and in the instant case was calculated, by the application to the value of the Fund of a sliding scale of percentages.

The Role of the Isle of Man Company

10. The Tribunal had before it a "Statement of Agreed Background Facts" which had a number of documents incorporated into it by reference, including correspondence between the Administrator and the Guernsey Society of Chartered and Certified Accountants, who had written to him on behalf of the Taxpayer and other taxpayers with similar claims. It also heard evidence from a director of the Taxpayer company. It made its decision on the basis that the facts were not in dispute. It is worth setting out two passages from the case which describe the role of the Isle of Man company and which lay at the heart of the Taxpayer's appeal to the Tribunal and the Tribunal's decision.

11. The first passage summarised the evidence of the director of the Taxpayer's company in the following terms:

> "(i) [The Isle of Man company] always managed the [Taxpayer's] investment activities and the costs of this were allowed prior to 2001. [The Isle of Man company] selects the portfolio and buys and sells shares, collects accounts for dividends and submits accounts. One of its representatives makes occasional visits to Guernsey to get the feel of the shareholders' requirements. [The Isle of Man company] in fact does everything to ensure an easy life for the Directors. The commissions charged on the purchase of shares are included within the price of the shares. The management fee of £14,944 does not include acquisition costs. The investment management expenses were revenue in the hands of [the Isle of Man company].
>
> (ii) The instructions to [the Isle of Man company] were to maintain a balanced portfolio and the revenue has been relatively static. The management fee is based on the capital value of the assets. Dividends were not paid by the [Taxpayer] but the beneficial owners received income through a loan account. No fees were charged for specific transactions other than through the commissions."

12. The second passage reads as follows:

> "The Agreement specifies [the tasks of the Isle of Man company] as discretionary investment management, including dealing in investments, provision of nominee services, safe custody and ancillary services including the settlement of transactions, the collection of income and the effecting of administrative actions, together with the provision of valuations and statements of account."

The Decision of the Tribunal and the Question for the Determination of the Court

13. On the basis of the material before it the Tribunal found that the fees of £14,994 paid by the Taxpayer to the Isle of Man company during the year of charge were permissible management expenses in accordance with the Law. The question for the determination of the Royal Court was whether the Tribunal was correct in law in concluding that the management fees claimed by the Taxpayer were deductible from its income for the year of charge in question and were permissible management expenses in accordance with the Law.

The Decision of the Royal Court

14. The Lieutenant Bailiff largely concurred with the Tribunal's reasoning, agreed with the conclusion it reached and answered the question in the affirmative. He thought that the words "laid out or expended wholly and exclusively for the purpose of managing the company" in section 169 of the Law comprehended management in a broad sense, and not in a limited sense. Later in his judgment, after quoting the Tribunal's description of the tasks specified in the Agreement (see para. 12 above), he said the following:

> "The Tribunal concluded that such tasks, in its view, fell within a broad definition of management as regards a portfolio of investments and, taking into account the fact that commission was earned separately on transactions and charged as part of the cost of investments and changes of investment, concluded that the expenses of the management fees were wholly and exclusively expenses of management of the Company and allowed the claim for deductions made by the Company. In my judgment, the reasoning of the tribunal in reaching such a conclusion was, to a large part right. I agree with the conclusion which they reached."

The Grounds of Appeal

15. The grounds of appeal are set out in the Administrator's Notice of Appeal, are commendably succinct and read as follows:

> "The learned Lieutenant-Bailiff erred in law in concluding that the investment management expenses of £14,994 claimed by the Respondent as a lawful deduction from its income in respect of the Year of Charge 2001 were permissible management expenses because he gave the phrase "permissible management expenses" a wider meaning than he should have and, in doing so, failed to have proper regard to special regime (sic) for taxing resident investment companies under Part XIV of the

> Income Tax (Guernsey) Law, 1975, as amended, which distinguishes them from businesses."

The Adminstrator's Arguments in this Court

16. Mr. McMahon, who appeared for the Administrator not only before us but also before the Tribunal and the Royal Court, provided a written skeleton argument and developed the points in it orally before us. We summarise these, we hope accurately, as follows:

(a) The Lieutenant Bailiff was wrong to adopt a broad construction of the phrase "permissible management expenses" in section 169 of the Law;

(b) The Lieutenant Bailiff had paid too much regard to construing "managing" and its cognate "management" separately from the context of the words in the phrase "managing the company";

(c) The phrase "managing the company" does not go further than redressing the fiscal imbalance brought about by electing to use an investment company;

(d) In referring to "the management of the activities of the company" in his judgment, the Lieutenant bailiff impermissibly strayed beyond giving the material words in section 169 of the Law their ordinary meaning;

(e) The rationale behind the availability of the permissible management expenses deduction is to avoid investment companies being put at a disadvantage in comparison with investors holding investments directly;

(f) On the other hand, the entitlement to the deduction is not designed to create a tax advantage for those who hold investments using a company as an intermediary;

(g) The Lieutenant Bailiff ignored the distinction which should properly be made between taking decisions of a managerial nature and those decisions being acted upon. The latter element will not always be part and parcel of "managing the company";

(h) The effect of the Lieutenant Bailiff's approach was to equate the computation of an investment company's assessable income with that of a business, when it was clear that the overall scheme of the Law was to treat the two differently;

(i) "Permissible management expenses" in section 169 of the Law should be construed more restrictively than by equating the position of an investment company with a business. The statutory definition of that phrase has the hallmark of such a restrictive meaning because of the inclusion of the words "wholly and exclusively".

Our Observations on the Administrator's Arguments

17. As we have indicated, the Lieutenant Bailiff did construe the case "permissible management expenses" as having a broad meaning. In describing this conclusion in his judgment, the Lieutenant Bailiff equiperated it with the view of Lord Reid in Sun Alliance Assurance Company -v- Davidson (Inspector of Taxes) [1958] AC 184 that the phrase "expenses of management" in section 33(1) of the Income Tax Act 1918 should be given "a fairly wide meaning" (at p. 205).

18. Mr. McMahon submitted that the speeches in the House of Lords in the Sun Alliance case said nothing to the issue in the instant case as here we are considering the statutory definition of "permissible management expenses" and not the words "expenses of management". However, while it is true that in the Sun Alliance case the phrase under consideration was a different one, and there was no equivalent statutory definition of it in the 1918 Act, and also that the Tribunal may have overstated the applicability of that case to the instant one, we do not think that the Lieutenant Bailiff can be faulted for taking the view that the speeches in the Sun Alliance case, and that of Lord Reid in particular, were helpful while at the same time reminding himself, as he did, that it was the words of the Law and not the English statute that he had to construe.

19. What the Lieutenant Bailiff actually said in the material part of his judgment was that the words "laid out or expended wholly or exclusively for the purpose of managing the company" should be read as "comprehending management in a broad sense, and not in a narrow sense." This brings us to Mr. McMahon's complaint that the Lieutenant Bailiff failed to give the material words in section 169 their ordinary meaning.

20. This complaint sits rather uneasily with the fact that not one but two meanings of the statutory words have been advanced on the Administrator's behalf. The first in time (it appears early in the correspondence incorporated in the Statement of Agreed Background of Facts) seeks to limit their scope to what the Lieutenant Bailiff described as "corporate acts of managing the company" such as (but not necessarily limited to) "fees relating to audit, sealing documents and filing fees, and other fees relating to the corporate steps which a company must take from year to year, and especially an investment company must take, in order to remain in corporate existence."

21 The second is encapsulated in a sentence in the written submission made to the Royal Court on behalf of the Administrator and which is in the following terms:

> "The words should mean no more than the process of taking decisions about the management of the company and not participating in putting those decisions into effect as part of the company's day-to-day affairs."

22. In our view, the question as to whether one or other of the interpretations put on the statutory words by the Administrator or the construction chosen by the

Tribunal and the Lieutenant Bailiff is correct can only be answered by looking at the relevant words in section 169 in their context - something that the distinguished and highly experienced members of the Tribunal were particularly well equipped to do. When this is done it is apparent that there is absolutely nothing to indicate that what was intended by the States was merely to allow for the deduction of additional expenses incurred in relation to, as the Lieutenant Bailiff put it, the corporate acts of managing the company or, as the Tribunal described them, items of "statutory expenditure". Had the legislature wished to so limit the deductions it would and could have used different words which would have made this clear. As it is, there is nothing in the wording to suggest such a limited range of deductions and both the Tribunal and the Lieutenant Bailiff were right to reject this interpretation.

23. Turning to the Administrator's alternative construction we cannot find support in the relevant wording in section 169 for his attempt to limit management to "taking decisions about the management". In the first place, there is no such limitation contained in the relevant wording; in the second, we consider that the words used clearly convey a wider meaning.

24. Expenditure "for the purposes of managing" a company is not the same as, and is more extensive in its scope than expenditure "for the purpose of management". Furthermore "managing" a company seems to us to mean taking responsibility for the activities of the company and does not, in our view, convey decision making to the exclusion of execution. In the instant case, because the company is an investment company by definition "[its] activities consist wholly or mainly in the making of investments." Therefore, items of expenditure laid out or expended wholly or exclusively for the purpose of managing those activities are deductible, subject only to the limitations and exclusions expressed in the definition in section 169.

25. The Tribunal and the Lieutenant Bailiff concluded, correctly in our view, that as expenditure for the purpose of managing the activities of an investment company is not the same thing as expenditure on the purchase or disposal of its assets, the direct expenses of acquiring or disposing of the same are not deductible as "permissible management expenses" and, therefore, if any such expenses had been included in the claimed deduction of £14,944 it would properly have been disallowed. However, it has not been suggested that any such expense was so included and looking at the list of items covered by the "investment management fees" set out by the Tribunal there is nothing that we can see that does not meet the "wholly and exclusively for the purpose of managing the company" requirement.

26. What we have said disposes of Mr. McMahon's argument that the interpretation put on the definition of deductible expenses by the Tribunal and the Lieutenant Bailiff and endorsed by this Court equates the position of investment companies with that of businesses. Even if this were to be the effect of the legislation in a given case this, of itself, would not displace what we regard as the clear meaning of the material words in section 169. We do, of course, agree with Mr. McMahon, as did the Lieutenant Bailiff, that the requirement in the definition that, to be deductible, an item of expenditure

must be a permissible deduction of a business constitutes a limitation on deductibility but this did not and does not arise as an issue in the instant case.

27. As to Mr. McMahon's point that the phrase "permissible management expenses" has the effect of hallmarking a restrictive meaning for the phrase, this was an allusion to a comment by Carnwath LJ in the case of J M Atkinson (HM Inspector of Taxes) -v- Camac PLC [2004] EWCA Civ. 541 on the Sun Life case which reads as follows (at para. 26):

> "There is nothing in the speeches which supports the view that an activity which is part of [the decision to purchase] ceases to be management, merely because it may also assist in the purchase if it is decided upon - still less if it is not. Unlike the provisions relating to Sched D expenses, there is no requirement that the expense should be "wholly and exclusively" related to management."

(See also para. 20 of the judgment of Patten J at first instance [2003] EWHC 1600 (Ch)).

28. We do not accept Mr. McMahon's hallmark argument. The "wholly and exclusively" requirement does not colour (or, as the Lieutenant Bailiff put it, does not narrow) the succeeding part of the definition of "permissible management expenses"; it is merely another requirement that has to be met before an item is deductible. Mr. McMahon did not seek to argue before this Court or the Lieutenant Bailiff that if the Tribunal was correct in its interpretation of the scope of the definition it was open to the Administrator to seek to challenge its findings of fact that the items of expenditure were laid out wholly and exclusively for the purpose of managing the Taxpayer company.

The Taxpayer's Submissions

29. Up to this point we have not mentioned the arguments advanced to us by Mr. Ferbrache on behalf of the Taxpayer. Although attractively put, for the most part they reiterated the points taken in the Taxpayer's favour by the Tribunal and the Lieutenant Bailiff and as we have indicated our general acceptance of these when dealing with Mr. McMahon's arguments it is not necessary for us substantially to repeat ourselves by going over much the same ground again. There was, however, one point made by Mr. Ferbrache which seemed to us not only to be correct but also to provide powerful support for the taxpayer's case.

30. There are two exclusions at the end of the definition of "permissible management expenses" in section 169 of the Law. For convenience we repeat the second of them: "(b) any expense of management which may be taken into account for the purpose of determining the amount of any additional deduction which may be claimable under the provisions of section thirteen of this Law." Section 13(1) of the Law reads:

> "If in respect of any year of charge, and subject to the provisions of the next succeeding subsection, the owner of any land or building situate in Guernsey proves that the

> cost to him of the maintenance, repairs, insurance and management in any such land or building, according to the average of the cost to him in the five years preceding that year of charge, has exceeded the amount to be deducted from the annual rental value on account of repairs as provided in section twelve of this Law he shall, in addition to the authorised deductions, be entitled to have the income which would otherwise be assessable in respect of the land or building on which the expenditure has been incurred reduced by the amount of the excess:
>
> Provided that the amount of such reduction shall in no case exceed the difference between the annual rental value of the said land or building and the authorised deduction on account of the repairs thereof."

31. Mr. Ferbrache's point was that the exclusions at the end of the definition in section 169 are obviously designed to ensure that investment companies do not receive double allowances and, in particular, (b) prevents an investment company which has invested in land or buildings in Guernsey from receiving double allowances under both section 162 and section 13 of the Law. However, as he further pointed out, because of the "wholly and exclusively" requirement, that eventuality could only arise if all the items listed in section 13(1) constitute "items of expenditure … laid out or expended wholly or exclusively for the purpose of managing the company." Therefore the maintenance, repair and insurance of any land or building in which an investment company has invested must constitute part of "the managing of the company" and expenditure on them must be "items of expenditure as are laid out or expended wholly and exclusively for the purpose of managing the company." But these activities go far beyond the scope of what the Tribunal described as "statutory expenditure" and patently involve not only decision making but also execution. It follows that in enacting this exclusion the legislature must have had in its collective mind "management in a broad sense, and not in a limited sense", to quote once more from the judgment of the Lieutenant Bailiff.

Disposition

32. It follows from the above that in our opinion the Royal Court gave the right answer to the question put to it and, as we have said, the Administrator's appeal must be dismissed.

