Judgment 44/2003

Bath Ltd v Administrator of Income Tax
Royal Court
(Civil Action File 657)
3rd November, 2003

Income Tax (Guernsey) Law, 1975 – appeal by way of case stated from Guernsey Tax Tribunal – whether profit on proceeds of sale of preference shares properly assessable to tax – distinction between income receipt and capital receipt – procedure followed by the Tribunal.

IN THE ROYAL COURT OF THE ISLAND OF GUERNSEY

The 3rd day of November, 2003 before Patrick John Talbot Esquire, QC, Lieutenant Bailiff, sitting alone:-

BATH LIMITED

Appellant

v.

THE ADMINISTRATOR OF INCOME TAX

Respondent

In the matter of the appeal by way of case stated from decisions of the Guernsey Tax Tribunal, on appeals from two assessments to income tax, given orally on 2nd July, 2001, the written reasons being issued on 10th May, 2002;

THE COURT, having on 14th and 15th October, 2003 heard Advocates St J. Robilliard and R. McMahon for the Appellant and the Respondent respectively thereon, this day ISSUED JUDGMENT in the terms attached hereto and ALLOWED the appeals against each of the tax assessments.

K. H. TOUGH
Her Majesty's Greffier

IN THE ROYAL COURT OF THE ISLAND OF GUERNSEY
Ordinary Division

BATH LIMITED

APPELLANT

v

THE ADMINISTRATOR OF INCOME TAX

RESPONDENT

Advocate St. John Robilliard for the Appellant, Bath Limited
Advocate Richard McMahon for the Respondent, The Administrator of Income Tax

J U D G M E N T
of Lieutenant-Bailiff Patrick John Talbot QC

1. This is an appeal from the decision of the Guernsey Tax Tribunal ("the Tribunal") given orally on the 2nd July 2001, when the Tribunal dismissed an appeal dated 18th August 2000 by Bath Limited, a Guernsey resident company incorporated on the 4th April 1997, ("Bath"), against two assessments to income tax in respect of two separate sums of £7,500 and £116,250 (being an aggregate of three separate payments) received by Bath in the tax years 1998 and 1999, ("the tax assessments").

2. Bath received these sums as part of the proceeds of sale of a total of 500,000 B Preference Shares in a United Kingdom company called Evenbrook Estates Limited ("Estates"), ("the Preference Shares"), to Evenbrook Group Limited, Estates' parent company, ("Group"), as a result of the exercise by Group on four separate occasions in 1998 and 1999 of call options, which had been granted to Group by Bath in a Subscription Agreement dated 15th July 1998 between (1) the shareholders in Estates, (2) Estates itself, (3) Group and (4) Bath ("the Subscription Agreement"). The Subscription Agreement was expressly stated to be governed by English Law.

3. 50,000 of the Preference Shares were sold, pursuant to one call option exercised in October 1998, for £57,750 and the other 450,000 shares were sold on three different occasions in the first half of 1999, namely, in January, March and June 1999, under three Notices given by Group, acting on each occasion by its English solicitors, to Bath on 29th December 1998

(50,000 shares), 26th March 1999 (50,000 shares) and 25th June 1999 (the remaining 350,000 shares) for a total aggregate sum of £566,250.

4. The sole issue on the appeal is whether part of the proceeds of sale of the Preference Shares on those four occasions was received by Bath pursuant to Schedule 6 to the Subscription Agreement as an income receipt, and was therefore taxable under Section 2 (4) of Income Tax (Guernsey) Law, 1975 ("the Tax Law"), or as a capital receipt or gain which was not therefore taxable at all under Guernsey tax law. With the exception of the Dwellings Profits Tax, (which plays no part in this appeal and can, therefore, for present purposes be ignored), Guernsey has no capital gains tax regime.

5. An oral hearing took place before the Tribunal on the 2nd July 2001. Advocate Robilliard for Bath appeared before the Tribunal and told me that the hearing took about four hours, after which the Tribunal, which consisted of five members, considered their decision privately for at least one hour. They then called the parties back into the hearing room and announced their decision to dismiss Bath's appeal against the tax assessments and said that they would provide a written decision later.

6. This they did when, on 10th May 2002, they handed down their written reasons, *i.e.* the Written Reasons were delivered to the parties about 10½ months after the oral hearing on the 2nd July 2001, during which hearing Mr Richard Godfrey Battersby, one of the two directors of Bath, had given oral evidence of some importance.

7. Mr Battersby is a Chartered Accountant and, together with his wife, (who is the other director of Bath), moved to live in Guernsey in, I think, late 1996. They set up Bath as an investment holding company in April 1997 and Mr Battersby's evidence to the Tribunal dealt with the history of Bath, with his experience over a period since 1972 as an investor in "well over 100" venture capital projects and with the negotiations with the directors of Group for, and the terms upon which, Bath agreed to invest £500,000 on the 15th July 1998 in the purchase of the Preference Shares. During the hearing on the 2nd July 2001, Mr Battersby was cross-examined by Mr Rob Gray, the Assistant Administrator of Income Tax, and also answered questions from the Chairman of the Tribunal and, perhaps, from one other member of the Tribunal. Mr Battersby's evidence was, as I have said, of importance; indeed, it was, as I see it, of central importance to the case, and it was recorded in summary form in paragraphs 6-13 of the Case Stated and also, in very similar terms, in the Written Reasons.

8. Before moving on to introduce the material terms of the Subscription Agreement and the amended Articles of Association of Estates, which came into being so as to permit the issue of the Preference Shares and their allotment to Bath, ("the new Articles of Estates",) it is necessary for me to say something about the procedural chorology of the case.

9. In the weeks before the hearing date the parties' representatives, Mr Gray for the Administrator and Mr Paul Murphy of BGL Reads Private Clients Limited ("BGL Reads") for Bath, corresponded and exchanged their differing views on the legal effect of the receipt by Bath from Group in 1998 and 1999 of the proceeds of sale of the Preference Shares, and, in the case of Bath, BGL Reads set out details of the factual circumstances leading up to the issue and allotment of the Preference Shares to Bath. It is clear that Mr Gray and Mr Murphy were attempting to persuade each other of the rightness of their respective positions, as expressed in this correspondence, but neither of them succeeded in persuading the other that he was mistaken. So the appeal hearing proceeded before the Tribunal on the 2nd July 2001.

10. The hearing proceeded under Part VII of the Tax Law, including the Third Schedule, which had been incorporated into the Tax Law in, I think, 1990. Although the procedure before the Tribunal was, by paragraph 5(2)(e) of the Third Schedule, permitted to be informal, the unofficial transcript helpfully prepared for this hearing by the parties' Advocates from the tapes of the morning session of the hearing, demonstrates that, in fact, the appeal hearing before the Tribunal proceeded with due formality. Advocate Robilliard opened the matter, referring to the Agreed Statement of Facts ("the Agreed Facts"), the Subscription Agreement, the new Articles of Estates and the Tax Law. He then called Mr Battersby to give his oral evidence and, after that evidence was concluded, Advocate Robilliard presented full argument on the facts and the law in his closing address to the Tribunal. Next, Mr Gray addressed the Tribunal, assisted by Ms Mandy Vinning of the Administrator's staff, who read extracts from the documents and cases relied upon by the Administrator. Thereafter, Advocate Robilliard, I think, made submissions in reply and then the Tribunal, as I have said, considered the matter privately for at least one hour before they announced their decision to dismiss Bath's appeal.

11. Despite the fact that Mr Battersby had given oral evidence, which was of central importance to the case and to which the Tribunal would have to give careful attention in preparing their written reasons, it took them very much longer, in my judgment, than it reasonably should have done to prepare their written reasons. Furthermore, when, soon after 10th May 2002, the date upon which they delivered their written reasons, the Tribunal were asked by Bath to state a Case, (since Bath had decided to appeal against their decision to the Royal Court,) it took them until 27th February 2003 to state a Case, a delay of a further 9½ months after they had

handed down their written reasons, even though the Case Stated was in almost identical terms to the written reasons. The Case Stated was, therefore, delivered to the Royal Court for the purposes of this appeal over a year and a half after the oral hearing had taken place before the Tribunal.

12. In my judgment in ***The Administrator of Taxes v Tremoille Properties Ltd***. (27th May 2002) I considered, in the context of that case, the extremely long time which it had taken the Tribunal to state a Case (about 22 months). I have decided that it is necessary to repeat in *this* Judgment what I said then about the delay by the Tribunal in stating a Case for the Royal Court. I quote from paragraph 14:

> "Perhaps there is some inherent indication that the time which might be thought appropriate for the stating of a Case by a Tribunal in Section 80(2) of the Tax Law, where a period of 21 days after the determination of the Appeal by the Tribunal is the time limit given for a party "*dissatisfied with the determination as being erroneous in point of law*" to require the Tribunal to state and sign the Case for submission to the Royal Court."

In my judgment, I doubt very much whether the Tribunal in this case should have taken longer than, say, three months after the oral hearing to have given their written reasons and I express the hope that on future occasions no undue delays occur again in either handing down written reasons or stating a Case. I stress that this is my personal view and that the circumstances of different cases may demand a different view being taken, but, in simple terms, especially after a hearing in which oral evidence is given before the Tribunal, it is preferable that the Tribunal should give written reasons for any decision, which has already been announced by them, within a short time, perhaps a very short time, after the decision has been announced. If they do so, their memory should remain fresh and their recall of the evidence and the submissions made to them, (assisted, no doubt by their own notes and, if they wish to see them, by the notes of the Clerk to the Tribunal, who is usually legally qualified,) should be relatively acute.

13. I shall now turn to the issue in the present appeal and I shall start by setting the scene, from the material documents and Mr Battersby's oral evidence, in some detail.

Facts Relevant to the Appeal

14. Apart from the Agreed Facts, the only factual evidence heard by the Tribunal, was the oral evidence by Mr Battersby; no other witness was called by either Bath or the Administrator, and the Tribunal did not exercise their power to summon a witness, which is contained in Section 78(5) of the Tax Law. But it is, I think, probable, on reading the Case Stated, that the Tribunal may also have accepted as proved facts some of what had been said by BGL Reads on behalf of Bath in the correspondence which preceded the oral hearing. I am, of course, bound on this appeal by the findings of fact made by the Tribunal, so long, that is, that they are true findings of fact based on the evidence and not, for instance, "facts" found by the Tribunal themselves by considering their own experience of business life and, especially, business life in Guernsey; I shall return to this aspect of the case later in this Judgment.

15. The Agreed Facts read as follows:

> "
>
> 1. Bath.. is a company incorporated in Guernsey.
> 2. Its principal activity is investment holding.
> 3. The schedule of investments for the year ended 31st December 1998 showed an acquisition of preference shares in a company by the name of [Estates] at a cost of £500,000. 50,000 shares were disposed of during the year at a profit of £7,500.
> 4. [Estates] is registered in the UK. The company was incorporated on 7th April 1994….Attached to this Statement as Appendix B is a letter, dated 17th April 2001, written by Mr C A Butterfield, a director of [Group].. in which he indicates that [Estates] invests in and manages UK residential property. He also states that in 1998 [Estates], through a subsidiary company, acquired a portfolio of property in Suffolk.
>
>   £500,000 was required to fund the purchase of the portfolio but the Group was at the limit of its borrowing.
>
> 5. Rather than provide a loan to [Group], Bath ..agreed to take an equity share in [Estates], by subscribing for preference shares.
>
> 6. Broadly, the share agreement provided that:

(a) Bath.. agreed to subscribe for £500,000 £1 B Preference shares in [Estates], at par, on 15th July 1998;

(b) Bath.. agreed to grant.. Group.. a series of options allowing it [to] purchase batches of the shares held by Bath.. during call option periods for a specified price;

- the first call option period ended on 30th September 1998 and the price was 115% of the par value of the Preference Shares;
- the second call option period was for the three months ended on 31st December 1998 and the price was 117.5% of the par value of the Preference Shares;
- the third call option period was for the three months ended on 31st March 1999 and the price was 122.5% of the par value of the Preference Shares;
- the fourth call option period was for the three months ended 30th June 1999 and the price was 127.5% of the par value of the Preference Shares.

(c) If… Group.. did not take up its options, Bath.. was able to exercise put options to sell its shares at a fixed price, if it did not wish to retain them.

A full copy of the [Subscription Agreement was] attached … as Appendix C.

Under the Terms of the Articles of Association of….Estates.., B Preference shares (that is, the class of shares subscribed for by Bath…) gave an entitlement to fixed cumulative preferential cash dividends, which were to commence fifteen months after the date of issue at the rate of 9% net per annum of the amount paid up on each share in issue on the dividend payment date. (See page 5 of the Articles of Association, which [were] attached … as Appendix D).

7. Attached … as Appendix E [was] a copy of the Accounts of….Estates…. for the year ended 30th September 1998 (which, in Note 17, makes reference to the shares issued to Bath..).

8. The shares, which were acquired on the 15th July 1998, were then redeemed as follows:

5th October 1998	50,000 shares	£57,500
January1999	50,000 shares	£58,750
March 1999	50,000 shares	£61,250
June 1999	350,000 shares	£446,250
		£623,750

9. Assessments for the Years of Charge 1998 and 1999 have been issued to include sums of £7,500 and £116,250 respectively. ”

16. Whereas the Subscription Agreement and the Articles of Estates were summarised in the Agreed Facts, this would, in my judgment, not prevent the Royal Court from finding, as a matter of law, that the true construction of either document differed from the way in which the documents had been so summarised. The true construction of documents of this nature is, generally, a question of law, in this case a question of English law.

17. I refer now to those parts of the documents attached to the Agreed Facts, which are, or may be, relevant to this Appeal.

18. The Subscription Agreement contained the following material parts:

(1) The moneys subscribed by Bath for the Preference Shares were agreed to be used by Estates to make a loan to its wholly-owned subsidiary, (which the parties to the appeal believed to have been Evenbrook (Suffolk) Limited), for the purpose of acquiring a property portfolio in Suffolk (Clause 4).

(2) Bath was given an effective veto on appointments to the Board of Directors of Estates (Clause 5).

(3) Bath was given substantial powers in respect of the conduct of affairs, *i.e.* the governance, of Estates, including obligations imposed on the directors of Estates to ensure that Estates should provide corporate forecasts to Bath before the end of each of its financial years for the next three years after the making of the Subscription

Agreement, and should also provide monthly management accounts and audited annual accounts (Clause 6.1 and Schedule 3, paragraph 2).

(4) Estates agreed that it would not, without the consent of Bath, which was not to be unreasonably withheld or delayed, inter alia, make any change in its Memorandum or Articles of Association, wind itself up or dissolve itself or make or permit any substantial alteration in the general nature of its business, make or execute any arrangement, contract or transaction of an unusual or onerous or long-term nature, cause its total borrowings and those of its subsidiaries, including bank overdraft and guarantees given, to exceed £27M or employ, dismiss or change the terms of employment of any director of Estates (Clause 6.3 and Schedule 4, paragraphs 1.1., 1.5, 1.10, 1.13, 1.14 and 1.15).

(5) It was also agreed that, whilst after the 30th June 1999 Bath remained a shareholder in Estates, Estates and the other parties to the Subscription Agreement would exercise their votes as shareholders, and where relevant as directors, to cause Estates, not without the written consent of Bath, to declare or distribute any dividends or other payments out of its distributable profits other than dividends in respect of the Preference Shares, as dealt with in Article 3.1 of the Articles of Estates, or to increase the remuneration of any of the directors or of any person related to a director (Clause 6.4).

(6) Schedules 5 and 6 set out the terms upon which, respectively, Group was given call options over the Preference Shares and Bath was given put options on the Preference Shares.

19. (1) The authorised share capital of Estates at the time at which the new Articles of Estates were agreed was £8.8M divided into 270,000 A preference shares, the Preferences Shares themselves and £8.0M ordinary shares (Article 2).

(2) Article 3 dealt with the payment of dividends in the manner set out in a table contained in Article 3.1. The Preference Shares had priority, during the period commencing 15 months after their issue, namely, in the period commencing on the 15th October 1999, over other shares, including the A preference shares, and the amount of dividend payable in respect of the Preference Shares was 9% net per annum of the amount paid up on each share issued on the dividend payment date. Dividends accrued from day to day (Article 3.2.3), were to be paid in half-yearly

instalments on the 15th April and the 15th October in each year, (Article 3.2.5), *i.e.* the first payment of a dividend on the preference share would be on the 15th April 2000, and Estates was obliged to cause each of its subsidiaries to keep it in funds so as to enable it to pay all dividends falling to be paid on the Preference Shares, so long as distributable profits existed within the subsidiaries (Article 3.3).

(3) Estates agreed to redeem all of the Preference Shares on one month's notice to Bath at any time during the period between the 1st July 1999 and the 30th June 2003, at a redemption price of 132.5% of the par value of the Preference Shares for redemption during the 3 months period commencing on the 1st July 1999 "*and such price shall be increased by 5% in respect of each subsequent 3 months period until the date of redemption,* …" (Article 4.1) [emphasis added by me].

(4) On any sale of all of the issued share capital of Estates the Preference Shares came first in priority to the other share (Article 5).

(5) Article 7 granted rights to the holders of the Preference Shares on the lines of the provisions of Schedule 4 to the Subscription Agreement.

20. I agree with Advocate Robilliard that the checks and balances which Bath possessed under the Subscription Agreement and the new Articles of Estates had the effect of impairing the independent corporate governance of Estates and that the directors of Group had negotiated away part of their independence in this area as part of the terms negotiated between Group and Estates, on the one hand, and Bath on the other hand in the period of about one month before the 15th July 1998. As Advocate Robilliard submitted, since Bath was not getting security in the ordinary sense of security over assets including real property, the only rights open to Bath to negotiate with Group and Estates were rights relating to the corporate governance of Estates. I would add, for the sake of completeness, that the transaction between the parties which led to the issue and allotment of the Preference Shares by Estates to Bath was, on the evidence given to the Tribunal by Mr Battersby, an arms' length transaction between independent, commercial parties, each of whom received advice from English solicitors.

21. The Tribunal also considered and took into account the annual accounts of Bath for the years ending 31st December 1998 and the 31st December 1999 and also the financial statements of Estates for the year to the 30th September 1998. The report of the directors of Estates for that year set out that Estates' principal activity was the acquisition, ownership and management of

residential property for letting and, in the section headed "Review of the business", it was disclosed that the 12 residential property companies within the group including Estates owned a large number of freehold and leasehold flats and houses, 15% of which were in East Anglia. The review continued as follows:

> "The Group's policy is to let quality unfurnished property on assured shorthold tenancies to private tenants. The charging of open market rents has assured that the Group's investment properties are maintained to the highest standard. … The pre-tax profits for the year … reflect … a 3 month contribution of Evenbrook (Suffolk) Limited – 142 quality residential properties in East Anglia acquired in June 1998 …"

22. Amongst the notes to the Financial Statements to Estates for the year to the 30th September 1998 was note 15, which disclosed that Estates had provided legal charges over its assets as security against borrowings of Group, which at the 30th September 1998 amounted to £15.9M, and that companies within the group had provided guarantees for the obligations of the group to its providers of finance. It was also disclosed in note 15 that Estates had granted security over its interest in Evenbrook (Suffolk) Limited to that company's provider of finance.

23. Note 17 to Financial Statements of Estates for the same year was, so far as is material, in the following terms:

> "
>
> B Preference shares - £500,000
>
> - are classified as "non-equity" shares under FRS4 "Capital Instruments"
> - have nominal value of £1 each and were issued at par in July 1998
> - are 9% fixed cumulative redeemable preference shares
> - redeemable/transferable at a premium subject to terms and conditions detailed in, inter alia, Articles of Association at the company's option
> - dividend entitlement commences in October 1999
> - are entitled to first priority repayments of capital plus any dividend arrears on winding up
> - attract voting rights in respect of class protection rights only as defined in the Articles of Association

- [dealt with the grant to Group of the call options]
- [dealt with the grant to Bath of the put options]
- [dealt with the final option granted by Group to Bath]."

24. The accounts of Bath for the years to the 31st December 1998 and the 31st December 1999 were audited by BGL Reads. They disclosed the investment by Bath in the Preference Shares and also disclosed directors' loan accounts which, in all probability, financed that investment. The accounts for both years disclosed gains on sales of investments, and it appeared to be common ground between the parties at the hearing before me that the "profit" comprised in the proceeds of sale of the Preference Shares pursuant to the call options was included in such gains.

25. Amongst the correspondence considered by the Tribunal at the hearing were letters, which appear at pages 296, 298, 299 (the Notice of Appeal including Bath's grounds of appeal), and 301-304, (an important letter, I think, both because its contents were set out by the Tribunal in paragraph 18 of the Case Stated and because of the attention given to it at the hearing before me), and, in chronological order, letters appearing in the correspondence bundle used in the hearing before me at pages 40, 39, 38, 36, 24-29, 21-22, 20-20A, 18-19, 10-11, 7-8 and 1-4. I consider that the points made in this correspondence need not be set out in this Judgment in great detail, since they were, largely, made again in argument before me. Nevertheless, I think it may be helpful to note, in summary form, some of the points made on behalf of Bath and the Administrator.

26. In the correspondence Bath contended, inter alia:

- that it had invested in the Preference Shares "with a view to capital profit over a period." [page 296]
- Bath wanted to take an equity stake in Group as it considered that Group had "the potential to be a good investment, given its performance to date", but the directors of Group were unwilling to reduce their equity holding and so "an arrangement was eventually agreed" under which Bath invested in the Preference Shares. [pages 301-302]

- Bath could be forced to sell the Preference Shares "even if it did not want to sell. [Group] could only force the issue, however, if it had generated sufficient funds from asset disposals." [page 302]
- the put options provided Bath with an exit route in the event that Group did not exercise the call options. [page 302]
- "The redemption premium … was set at a level that would induce Bath to invest, as Bath was aware that there was a possibility that it may not be able to retain its shares for the longer term, even if the directors [of Bath] wanted to." [page 302]
- there was no security for the Preference Shares and the outcome of the investment in them "could not be guaranteed". [page 302]
- the decision by Group to exercise its call options to buy back the Preference Shares was taken by Group, and not by Bath. [page 302]
- in the absence of available security, Group or Estates could provide no commercial terms for a loan to a potential lender. [page 303]
- the Preference Shares were issued "which offered the prospect of an annual return of 9%, plus the possibility of being able to hold equity should [Group] not meet its targets." [page 303]
- no annual interest was receivable by Bath whilst it held the Preference Shares and the first dividend was due for payment after 15 months. [page 303]
- Bath invested on a long-term basis, but was denied the opportunity of receiving annual dividends and enjoying capital growth. [page 303]
- for the above reasons, Bath contended that investing in the Preference Shares was not equivalent to investing in a loan bearing interest at a fixed rate. [page 303]
- Bath's investment in Estates "ha[d] all the hallmarks of a high risk investment." [page 304]
- in seeking to tax Bath to income tax in the tax assessments the Administrator was seeking to apply a form of capital gains tax to profits realised by Bath, an investment

company, from the disposal of assets held for a short period of time, in circumstances where the Preference Shares were sold at Group's option and against Bath's wishes. [pages 24-29 and 1-4 of the correspondence bundle.]

27. The Administrator's arguments expressed in the correspondence included:

- under the put and call option arrangements Bath would have enjoyed a return fixed at the outset. [page 298]
- the return actually enjoyed by Bath was received within 12 months, which did not fit with the statement by BGL Reads that Bath had invested with a view to capital profit over a period. [page 298]
- Bath had received a very speedy return on its capital. [page 298]
- (for the reasons set out in the previous three bullet points) the arrangement was a loan bearing interest at a fixed rate or Bath had embarked on an adventure in the nature of trade, (which was an alternative argument which, in due course, during the correspondence before the oral hearing, the Administrator dropped). [page 298]
- accordingly, the profit on disposal of the Preference Shares was income in nature. [page 21 of the correspondence bundle]
- if Bath had held the Preference Shares for 3 years, and during that period had enjoyed dividends, and had subsequently disposed of the Preference Shares, it was unlikely that the Administrator would have made any enquiries or that the existence of the Subscription Agreement would have come to his attention; "the underlying gain would, in all probability, have been treated as a capital gain". "In such a scenario, the situation would be that the one year period during which … Group … could repurchase the shares from Bath … would have long expired, the value of those shares would have once again become subject to the full effect of market forces (and would have been so subject for two years) and Bath … would have been entitled, for

one year and nine months to what would have undoubtedly been a taxable income stream (being the dividend). Assuming there were no other factors affecting the transaction, I can confirm it is probable that any tax liability would have arisen on the dividend only." [page 19 of the correspondence bundle]

- whereas usually there may be a great deal of financial risk involved in entering into a share agreement, the use of options as in the instant case was not normal and "had the effect of significantly limiting the risk to Bath." [page 8 of the correspondence bundle]
- the fact that the parties to the Subscription Agreement agreed the inclusion of the put and call options supported the argument that Group "had wanted to borrow the funds and never anticipated a long term equity partner but simply a provider of finance." [page 8 of the correspondence bundle]

28. Since the Case Stated was in almost the same terms as the Tribunal's written reasons delivered on the 10th May 2002, I do not propose to refer to the written reasons further in this Judgment, but only, where appropriate, to the Case Stated.

29. For the purposes of this appeal, it is sufficient, I think, for me to set out the oral evidence of Mr. Battersby in the terms of paragraphs 6-13 of the Case Stated, which were in the following terms:

"6. **The evidence on behalf of Bath** was given by Mr. R.G. Battersby ("Mr. Battersby"), one of its Directors. He was present throughout the hearing and gave oral evidence that he was a Chartered Accountant with extensive experience in Venture Transactions. Since 1972 he had been involved in over 100 such transactions both in setting them up and on occasion by personal involvement. Bath was set up in 1997 as an

investment holding company, of which he and his wife are directors, and has invested in 6 such venture capital projects.

7. Mr. Battersby said that he had known a Mr. Chris Butterfield ("Mr. Butterfield") for some 12 years and knew of his interest in venture capital projects. Mr. Butterfield lived in England. Mr. Butterfield asked him to lend a sum of money urgently needed to conclude a property transaction in England.

8. Mr. Battersby was unwilling to make such a loan due to lack of security and insufficient return. A proposal for a loan was then renegotiated as a venture capital project. He referred the Tribunal to the Subscription Agreement … The Put option that it contained by which Bath could require … Group … the parent company of … Estates, to purchase Bath's preference shares in … Estates, was a proposal of Mr. Battersby. As a *quid pro quo*, Mr. Butterfield required that … Group have a Call Option enabling it to purchase Bath's preference shares. Mr. Battersby stressed that the agreement was the result of about a month of negotiation and was prepared by legal advisers.

9. Mr. Battersby stated that Bath was making an investment in preference shares. The sums set out in the Subscription Agreement assumed satisfactory performance by … Estates but Bath wanted to be able to keep control of the situation if things went wrong. He regarded the investment as one extending to 2003, the usual length of a venture capital project. In cross-examination he stated that the Put Option was of no real value if things went wrong, other than being a way of inducing negotiation.

10. Mr. Battersby also stated that if the transaction had been one involving loan stock, then the instrument would have described Bath as a creditor. Preference shares were share capital and participated in a fixed rate of return.

11. He went on to say that the values placed on the Call Options reflected what was acceptable at the time given the level of risk involved. The Call Options enabled Group to buy out Bath since Mr. Butterfield did not want to have a business partner. The Put Option represented Bath's early redemption option for the Preference Shares that it purchased. This was his only dealing with Evenbrook Group.

12. Mr. Battersby told the Tribunal that the arrangement of Put and Call Options was to be found in about 25% of the venture capital deals that he has been involved with. He stressed that the contract, drawn up by Nabarro Nathanson of Sheffield, was a true representation of what had been agreed. The Evenbrook Group received separate legal advice. The Evenbrook Group needed a half million pounds to complete a deal and time was of the essence. For Bath the use of preference shares represented less risk than ordinary shares.

13. In response to questions from the Tribunal, Mr. Battersby said that a high profit was there for Bath if the deal went to its conclusion and so Bath did not want to be bought out. Mr. Battersby was not sure how the Evenbrook Group were able to buy out Bath so quickly but he surmised that other loans had come in or assets realised. Mr. Battersby had confidence in the investment due to the quality of the people involved

> although he accepted that he had not seen the consolidated accounts of the Evenbrook Group, only those of Estates. He also stated that he had never seen the properties involved. He accepted that £1.6M was paid by … Estates in 1997 by way of an interim dividend on its ordinary shares (Estates …, Note 8 relating to its Financial Statements year ending 30th September – Appendix E to the Statement)".

30. It is noteworthy that nowhere in the Case Stated did the Tribunal criticise, or express their disbelief in, any part of Mr. Battersby's evidence. Indeed, within the context of paragraph 33 of the Case Stated, they said that they did *not* criticise Mr. Battersby. In these circumstances, the Tribunal have to proceed, (as I do as well,) on the basis that Mr. Battersby's evidence was accepted, and Advocate McMahon also expressly conceded that this was so. It should also be recorded that, although Mr. Battersby was cross-examined by Mr. Gray and questioned by the Tribunal themselves, nobody at the oral hearing criticised his evidence or expressed any dissatisfaction with his evidence. If the Tribunal had disbelieved or doubted the accuracy of any part of Mr. Battersby's evidence, it was, I believe, incumbent on them to have raised their concerns as to his credibility as a witness with him during the course of his evidence at the oral hearing, when he would have been able to focus on such concerns and reply, insofar as he could, to any material and admissible questions. Furthermore, I strongly doubt whether it was proper, in a legal sense, for the Tribunal to have reached the conclusions about Mr Battersby contained in paragraphs 32(6) and (7) and 33 of the Case Stated without first having challenged Mr Battersby on those parts of his oral evidence which they have, in effect, *not* accepted in reaching these conclusions.

31. It was made clear at the hearing before me by Advocate McMahon in open and frank terms that the Administrator did not challenge or criticise Mr. Battersby's evidence or his conduct in investing, through Bath, in the Preference Shares.

32. After setting out Mr. Battersby's evidence, the Tribunal summarised the Administrator's arguments (paragraphs 14-21 of the Case Stated) and Bath's arguments (paragraphs 22-29 of the Case Stated).

33. It is not necessary for me to rehearse in this Judgment much of the way in which these arguments were summarised by the Tribunal, since, of course, the matter was fully argued by Counsel before me. But I should deal here with one matter. There may, I think, be a reasonably strong hint, (both in paragraph 21 and, later, in paragraph 35 of the Case Stated), that the Tribunal did not necessarily agree with the decision of Mr. Gray taken before the hearing not to pursue an argument on behalf of the Administrator that, in investing in the Preference Shares, Bath was involved in a venture in the nature of trade and that therefore the profits received on the sales of the Preference Shares under the call options were taxable as income. Advocate Robilliard argued that, because of this possible disagreement with Mr. Gray, the Tribunal had allowed themselves to trespass into that area whilst considering Bath's appeal. If the Tribunal had, in fact, allowed themselves to have "gone down that road", despite Mr. Gray's clear prior agreement with BGL Reads not to do so, they would, in my judgment, have erred in doing so; but, despite Advocate Robilliard's persuasive argument that the Tribunal had so erred, (during which he graphically argued that "trading had left its fingerprints" on the Case Stated,) it is not sufficiently clear to me, from a careful re-reading of the Case Stated, that they had in fact gone that far or that, if they had done so, that they had allowed their untested views on the question in some way to have coloured the way in which they considered the appeal on the issue argued before them. I, therefore, reject Mr. Robilliard's argument on this point.

34. The findings of the Tribunal were set out in some depth in paragraph 32 of the Case Stated. In sub-paragraphs (1)-(3) the Tribunal found as follows:

"

> (1) Bath Limited, by itself or by its Director Mr. Battersby, was familiar with venture capital undertaking and the risks involved.
>
> (2) The arrangement as set out in the Subscription Agreement was arrived [*sic*] after a period of negotiation and with the benefit of professional advice.
>
> (3) The result of the arrangement between the parties was a disposal of the preference shares in … Estates by Bath at a profit of £123,750 over their cost price."

These findings are uncontroversial and clearly right on the evidence heard by the Tribunal and on the basis of the Agreed Facts.

35. But it was in paragraph 32(4) of the Case Stated that, in my judgment, the Tribunal went astray. In the words of Advocate McMahon, appearing for the Administrator in the hearing before me, "they went off on a frolic of their own"; it is clear that they did so without any invitation to do so from Mr. Gray and, in my view, they were clearly wrong to have done so. In my judgment, they seriously misdirected themselves as to the evidence of Mr Battersby, which was largely unchallenged, and reached conclusions contrary to the weight of the evidence. Furthermore, I consider that they did far more than rely upon their own experience, in the way that finders of fact sometimes do when exercising a judicial or quasi-judicial function; they appear to me to have seriously misunderstood the way in which the option provisions in Schedules 5 and 6 to the Subscription Agreement, and the redemption provisions in Article 4.1 of the new Articles of Estates, operated, and I have reached the clear conclusion that it was this misunderstanding which led them to say what they did in paragraph 32(4). Let me explain how I have reached this conclusion.

36. To do so, I should first read paragraph 32(4) of the Case Stated. It was in the following terms:

"(4) It was argued that the arrangements were a five-year venture capital deal. Based on the Tribunal's own experience, the nature of the deal differed radically from a normal venture capital deal for the following reasons:

(a) In a typical venture capital deal, investment risk is compensated by a potentially high rate of return, which is unpredictable and depends upon the success or otherwise of the company invested in. In the arrangements entered into by Bath, however, there was never the prospect of Bath receiving more than the fixed amounts stipulated by the Subscription Agreement or the Articles of Association of … Estates. Receipt of these amounts depended simply on (a) the ability of … Group to fulfil its obligations under the Subscription Agreement (as regards the share options) which in turn depended principally on … Group's cashflow rather than its profitability, or (b) the solvency of the company over the period to July 2003 (as regards redemption of the preference shares).

(b) Another unusual feature of the arrangements was that the annual rate of return to Bath would be at its lowest if its shares were held to maturity. This would produce a fixed return of 33.75% over the five year period July 1998 to July 2003, equivalent to 6.675% per annum, compared, for example, to a return of 27.5% over the period of less than one year to 30th June 1999. Broadly, the longer Bath held its investment, the lower the annual rate of

return would be. On the basis that risk increases over time, this again was inconsistent with the normal venture capital concept.

(c) From the evidence … Estates' problem at the time of the arrangements was a shortage of funds rather than poor business conditions. There was little evidence that … Estates was a particularly risky investment. Mr. Battersby certainly made little reference to any effort to assess the risk involved, relying mainly on his acquaintance with Mr. Butterfield. Again, this seemed unusual for a venture capital situation, but more consistent with a short-term funding exercise.

(d) The Tribunal noted that … Estates was not a start-up venture but a going concern with a profitability record. This is not a typical venture capital business profile."

37. So, in paragraph 32(4) of the Case Stated, the Tribunal were expressly relying upon their own experience of what they called a "normal" or a "typical" venture capital deal and concluded that "the nature of the deal differed radically from a normal venture capital deal for a number of reasons". It was common ground before me that the Tribunal were not encouraged to do this, but did it of their own volition and without, largely, testing their views or "their own experience" with either side during the oral hearing on the 2nd July 2001.

38. There was no evidence before the Tribunal, apart from Mr. Battersby's clear evidence of *his* experience, about venture capital deals and the Tribunal did not summon a witness to give any such evidence to them. Instead, they sought to rely upon their own experience. In my judgment, they were ill-advised to have done so and I am forced to conclude that they seriously misdirected themselves in law in doing so. There was simply no evidence before

them which entitled them to do so and, in the circumstances of the present case, they were, in my judgment, wrong in law to rely upon their own experience in the way in which they did.

39. Perhaps one of the most serious errors made by the Tribunal was that made in paragraphs 32(4)(b) and 32(5) of the Case Stated. For, in these paragraphs the Tribunal made a startling mathematical error, which seems to me to have formed the probable basis upon which much of their later reasoning depended. In contradiction of the clear wording of Article 4(1) of the new Articles of Estates, they concluded that

> "the annual rate of return to Bath would be at its lowest if the shares were held to maturity …Broadly, the longer Bath held its investment, the lower the annual rate of return would be. On the basis that risk increases with time, this again was inconsistent with the normal venture capital concept… Equally, Bath had a strong incentive to exercise its Put Option on or shortly after 30th June 1999 since there was no benefit in delay. This implied an unusually short period for a venture capital deal."

Using simple division, the Tribunal concluded that the annual rate of return to Bath on holding the Preference Shares until the 30th June 2003 was 6.675% per annum, whereas Counsel agreed or accepted that over that period the total return would be 207.5%, an average during a postulated five years period of holding the Preference Shares to maturity of 41.7%. So, far from it being "Bath's least attractive option" to hold the Preference Shares to redemption on the 30th June 2003, it would have been Bath's best option to have achieved this so long, of course, as Estates had sufficient funds then available to redeem the Preference Shares. This fundamental mistake must, in my judgment, have led the Tribunal seriously astray in the manner in which they assessed Mr Battersby's evidence and I believe that it probably also led them to rely upon their own experience in reaching their decision.

40. Advocate McMahon did not seek to support the reasoning of the Tribunal in his submissions to me on behalf of the Administrator. He accepted, and, indeed, volunteered, that the Tribunal had gone seriously astray in paragraph 32(4) of the Case Stated, and he said, with typical openness, that he could not support the reasoning of the Tribunal, and did not wish to do so. Nevertheless, Advocate McMahon argued that, even without any reasoning of the Tribunal appearing in the Case Stated upon which he could properly rely, his primary contention still stood, namely, that the receipts of the sale proceeds of the Preference Shares by Bath from Group included, in the profit element of those proceeds of sale, income in the hands of Bath and it followed that profit element was taxable under section 2(4) of the Tax Law as "income from other sources", a term which is not expressly defined in the Tax Law. As Advocate McMahon put it, the sole question remains: Were the receipts of those parts of the proceeds of sale of the Preference Shares which exceeded their par value income, and therefore subject to assessment to income tax, or capital gains, and therefore received free of any liability to pay tax in respect of them?

41. The only safe course, in my judgment, is to ignore the reasoning of the Tribunal, which is contained in paragraphs 32-33 of the Case Stated, and this is what Counsel on each side, no doubt for slightly different reasons, asked me to do. In my judgment, it is right that I should do so. I have also concluded that, since I consider that it is possible for me to decide this appeal myself without the need to remit it to a differently-constituted tax tribunal for a re-hearing, it is in the interests of justice, and, I hope, also in the interests of the parties themselves, that I should not remit the appeal and should decide it now.

42. I turn, therefore, to deal with the sole issue arising on this appeal without further consideration of the Case Stated. This issue is: Were the "profits" received on each of the four separate sales of the Preference Shares by Bath to Group capital receipts or income receipts in the hands of Bath?

43. There is no authority under the law of Guernsey, which directly assists either side on the appeal. But Counsel on each side cited several English authorities in support of their arguments and, although they are not, of course, binding upon the Royal Court, I have found them of value in this case, especially since the Subscription Agreement is expressly governed by English law and the new Articles of Estates relate to a UK company. If I need to do so, in relation to the limited issue before the Royal Court on this appeal, I find that the law of Guernsey closely resembles the law of England before capital gains tax was introduced in the United Kingdom in, I think, about 1965. I am satisfied that, in the current circumstances, it is proper to do so and that there is no obvious reason not to do so.

44. First, it is, in my judgment, right in principle, as Advocate Robilliard argued, that, in order to answer the question on the appeal, one must look at the structure of the transaction, which appears from the relevant documents and facts as at the date on which Bath acquired the Preference Shares, namely, the 15th July 1998, and, that, in doing so, the Court will be able to identify whether any profit which might thereafter be received by Bath on any exercise of Group's call options, or, indeed, on the exercise of any of Bath's own put options, would be received by Bath as capital or as income.

45. It would, equally, in my judgment, be wrong in principle to construe the relevant parts of Schedules 5 and 6 to the Subscription Agreement, and of Article 4.1 of the new Articles of Estates, in different ways depending on how much of the period between the issue of the Preference Shares on the 15th July 1998 and the final redemption date on the 30th June 2003 might remain on the date or dates of receipt by Bath from Group of the proceeds of sale of part or parts, or indeed all, of the Preference Shares. In my judgment, the relevant provisions were capable of one legal meaning only throughout the length of any period between the 15th July 1998 and the 30th June 2003 during which Bath may have continued to hold some or all of the Preference Shares.

46. I, therefore, reject Advocate McMahon's argument in so far as it includes a submission that the answer to the question on the appeal may depend on how far along the road to the final redemption date of the 30th June 2003 the sale or sales of the Preference Shares by Bath to Group under call option notices may, in fact, take place.

47. In my judgment, the answer to the question on this appeal cannot, using Advocate McMahon's word, "shift" once, say, sufficient time has elapsed after the 15th July 1998 to allow Bath to receive, or become entitled to, dividends under Article 3.1 of the new Articles of Estates. I think that this submission, in fact, discloses the fallacy in this part of the Administrator's argument. This argument seems to me to be an example of a "Heads I win, Tails you lose" argument. The Administrator's argument, in my view, runs like this: until Bath receives, or becomes entitled to, dividends from Estates, there is no taxable income stream *and so* any profit element received in the period up to the 15th October 1999, or perhaps up to the first dividend payment date of the 15th April 2000, *must* be income, whereas if Bath were to receive any such profit element after such date, the profit would somehow shift in legal character so as to become a capital gain and, as a result, not be assessable to income tax, whilst any dividend income would, for obvious reasons, be so assessable since dividends would clearly be received as income (the italics are mine). I agree with Advocate Robilliard that the Administrator cannot, as it were, have it both ways, which I consider he is trying to do in this part of his argument.

48. But this conclusion of mine does not, I think, fully dispose of the appeal in Bath's favour. For it is still open to the Administrator to contend, (and he does so,) (i) that, despite the labels which the parties to the transaction, namely, the parties to the Subscription Agreement, may have used, in strict legal analysis what they created was a transaction equivalent to a loan, (ii) that the profit element in the proceeds of sale of the Preference Shares amounted to moneys received as interest and (iii) that Bath is, therefore, assessable to income tax on this profit element.

49. It was expressly conceded by Advocate McMahon, as I believe it was correct for him to do, that the transaction was not a sham or a smokescreen for a loan. But, in his oral argument, he argued that, although on the face of the Subscription Agreement and the new Articles of Estates it "looks like a subscription for a shareholding followed by the exercise of share options by a third party", in reality what the parties agreed was for Bath to provide funds on the basis that, when the funds were returned to it, whether by Group or by Estates, with an agreed percentage increase, *i.e.* the profit, the true construction of the arrangement is that the parties agreed a loan by Bath to Estates, which would be repaid by either Estates or by its parent company Group, with an income element in the repayment which would, when received, amount to "income from another source" within section 2 (4) of the Tax Law, and would, therefore, be subject to income tax. For the avoidance of doubt, I find, without hesitation, that the substance of this argument is open to Advocate McMahon despite the terms of paragraph 4 of the Agreed Facts, which, to repeat them, read:

> "Rather than provide a loan to [Group], Bath ..agreed to take an equity share in [Estates], by subscribing for preference shares."

50. Advocate Robilliard argued that Bath's investment was a capital investment, which had both an income element in the entitlement to future dividends in priority to other shareholders of Estates and a capital element in the redemption rights either under the call and put options or under Article 4.1 of the new Articles of Estates, which element reflected a capital risk wholly different from a loan arrangement.

51. The English authorities cited by Counsel, in their able and helpful written and oral arguments, relate, I think, to issues which are analogous to the issue in the present case, rather than being directly in point, but they have been of some assistance to me in deciding the appeal. I need only refer to two of them.

52. Both parties relied upon the exhaustive judgment of Lord Greene MR in ***Lomax v Peter Dixon & Son Limited*** (1943) 25 TC 353 in the Court of Appeal in England in support of their arguments. In that case notes were issued which were redeemable over a 20 years period, but the first redemption took place very soon after the issue of the notes. The companies concerned were, unlike in this case, connected or related companies, and the transaction converted a loan to something else, namely, redeemable notes, 5% of which were to be redeemed annually.

53. The Court of Appeal held that no part of the redemption payments rendered the payee liable to income tax even though some of these payments were very short-term. Lord Greene gave several examples of what he suggested were possible scenarios in which funds might be provided from A to B, or existing loans refinanced or restructured. The most relevant to the present case is, in my judgment, that dealt with at p. 364 of Lord Greene's judgment in which A lent £100 to B at a reasonable rate and stipulated payment of £120 on maturity of the loan where the £20 could either have been analysed as compensation for accepting a capital risk or analysed as deferred interest. Lord Greene's approach was that if extrinsic evidence of the negotiations between the parties established that the £20 was compensation for the capital risk, the £20 should not be treated as income. As is stated in paragraph B5.202 of *Simon's Direct Taxes Service*, commenting on ***Lomax v Dixon***:

> "The premium on redemption, however, rarely represents the whole of the "risk attaching to the investment" [quoting this phrase from Lord Greene's judgment at p. 360]. If it did, the appropriate rate would not be greater than that of "gilt-edged" securities. As the element of risk is always one of the constituents of the commercial interest rate, the non-taxability of a premium on redemption would seem to depend upon its assuming effectively the form of a capital payment."

54. The other case which I believe it is helpful to consider is the decision of the Court of Appeal in England in ***Paget v Commissioners of Inland Revenue*** (1937) 21 TC 677, upon which Advocate Robilliard placed reliance. At pp. 691/2 Sir Wilfrid Greene MR dealt summarily in rejecting an argument raised by the Commissioners that the purchase-price received by the Hon. Dorothy Paget, the taxpayer, on the sale to an independent third party of interest coupons on bonds, in respect of which there had been a partial default of payment of interest, amounted, within the terms of the relevant English income tax statute, to "interest arising from" the bonds, by concluding that the purchase-price "… arose from contracts of sale and purchase whereby Miss Paget sold whatever right she had to receive such income in the future, as well as her right to take what was offered by the defaulting debtors.."

55. But, unlike in that case where the sales of the coupons were to a stranger to the original transaction, the sales and purchases of the Preference Shares by Bath to Group in this case arose out of the very same transaction which the Court must analyse to determine the appeal and, in my judgment, on the facts and documents in issue here, ***Paget*** does not provide Bath with a quick solution or otherwise assist Bath. The answer is not so simple.

56. Although there are *some* indications that the transaction in the present case should be interpreted as a commercial interest-bearing loan on more complicated terms than those in a normal loan facility, I conclude that the true analysis of the transaction is that the "profit" elements in the sale proceeds of the Preference Shares were capital receipts, which included capital gains received on the realisation of investments by Bath in Estates, and not income receipts, and that any dividends received by Bath during any period in which it continued to hold some or all of the Preference Shares would be received as income for which Bath would have been assessable to income tax under section 2(4) of the Tax Law.

57. In my judgment, the following factors arising from the Subscription Agreement and the new Articles of Estates, read in the light of the admissible extrinsic evidence of Mr Battersby

heard by the Tribunal, strongly suggest that the profit element in the proceeds of sale of the Preference Shares was received as capital, and not as income, and that any dividends which might be received would be received as taxable income:

(1) the parties engaged in about one month of negotiation at arms' length, with solicitors involved on both sides;

(2) there was no indication of any sham or smokescreen involved in the documents which governed the transaction;

(3) during these negotiations it became clear that the Evenbrook group was unable to raise funds for the purchase of properties in East Anglia, which it urgently wished to purchase, from its usual providers of funds and there was no security available against which Bath might lend funds to either Group or Estates;

(4) but it also became clear to Mr Battersby during these negotiations that Mr Butterfield and his fellow shareholder in Group were unwilling to release any of their equity shareholding in Group to Bath in exchange for the sum of £500,000 to which the negotiations related;

(5) the result of the negotiations was that Bath would provide £500,000 in exchange for shares which would enjoy the highest priority in relation to dividends and a right to capital repayment on dissolution prior to other classes of share, namely, the Preference Shares, with dividends being payable on them but being deferred for the first 15 months of a maturity period of just under five years, and with substantially increasing premiums payable on any exercise of the call or put options negotiated between Mr Battersby and Mr Butterfield;

(6) the rate at which dividends would become payable to Bath, as holder of the Preference Shares, for the period commencing on the 15th

October 1999, was agreed at 9%, which, in my view, in the circumstances pertaining in July 1998, was at or above a reasonable commercial rate of interest;

(7) there was a clear indication that there was a genuine capital risk in Bath's investment in Estates which was demonstrated both by the lack of security available for a loan and by the fact that the Evenbrook group, although apparently in a reasonably good financial condition, was unable to borrow the purchase-price of the properties in East Anglia from its usual providers of funds, *e.g.* its bankers;

(8) this capital risk cannot, in my judgment, properly be described as "pretty slim", as Advocate McMahon submitted;

(9) there was what I construe as an obvious advantage to Bath, in the absence of adverse trading results from Estates or Group, in holding the Preference Shares for as much of the maturity period as possible;

(10) the rights granted to Bath in the Subscription Agreement and the new Articles of Estates gave Bath a surprisingly large degree of corporate control over the affairs of Estates.

58. For these reasons I allow the appeal against each of the tax assessments.

Patrick John Talbot QC

Lieutenant-Bailiff

03 November 2003

