

THE SPECIAL COMMISSIONERS

THE TRUSTEES OF THE F D FENSTON WILL TRUSTS

Appellant

- and -

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

Respondents

**Special Commissioners: SIR STEPHEN OLIVER QC
 NICHOLAS ALEKSANDER**

Sitting in public in London on 16 January 2007

David Goldberg QC and Hui Ling McCarthy, counsel, instructed by **Brecher Abram**, solicitors, for the Appellant

David Ewart QC, instructed by the acting solicitor for **HM Revenue and Customs**, for the Respondents

DECISION

Introduction

1. The Trustees of the F D Fenston Will Trusts (“the Trustees”) appeal against assessments to capital gains tax for the 1998 year, each in respect of £38,872.20. The issue in the appeal is the quantum of allowable losses accruing to the Trustees under section 16 of the Taxation of Capital Gains Act 1992.
2. The matter can be shortly summarized. At all material times and from a date in 1994, the Trustees owned all the shares in Daviebrook Investments Inc (“Daviebrook”). In 1994 they made a disposal of the shares for \$1. The question which arises is whether, on that disposal, the Trustees sustained an allowable loss. The answer to this question depends on whether, in computing the chargeable gains or allowable losses accruing on the disposal, the Trustees are able to deduct capital contributions, amounting to £1, 530,546 (“the Capital Contributions”), which they made to Daviebrook.
3. The facts were all agreed, as was a report on the Delaware law implications of the Capital Contributions provided by Mr Allen M Terrell Jr, lawyer and director of Richards, Layton & Finger PA of Wilmington, Delaware.

The Facts

4. Daviebrook was incorporated in 1981. It is a company formed under and governed by the laws of the State of Delaware. Its share capital consisted of 1,000 no par value shares of stock. The Trustees acquired all these shares in 1983 for \$1,000.
5. At all material times Daviebrook was concerned in various joint venture projects for developing property, principally in California.
6. Between 16 March 1983 and 5 April 1987, and while Daviebrook was solvent, the Trustees paid the equivalent of £1,530,546 to Daviebrook as Capital Contributions.
7. A document of 10 July 1984 headed “Action by Consent of the Board of Directors of Daviebrook” contains the written consent of the directors. Referring to \$325,000 “furnished” to Daviebrook on 16 March 1983 and \$250,180 on 2 June 1983 the document recites that Daviebrook “previously has resolved, and the Trustees have agreed, to treat [those amounts] as a contribution ... to paid-in surplus, such sums to be credited to the capital account of the Estate”. The operative part of the document resolves that that treatment “be and is hereby reconfirmed, approved and ratified”; it goes on to resolve that \$597,500 furnished by two cash payments of 13 January and 12

March 1984 be accepted and treated by Daviebrook “as additional contributions ... to paid-in surplus”.

8. Documents having similar effect dated 15 November 1984, 18 March 1986 and 31 March 1988 record further Capital Contributions. The aggregate of all the above Capital Contributions was \$2,192,125 (£1,500,006).
9. Referring to those Capital Contributions Mr Allen M Terrell Jr reported as follows:

“Although I found no Delaware case on point, it is my opinion that, assuming that at all relevant times the assets of the Company exceeded its liabilities, (which, as it is an agreed fact that the Company was solvent when the Contributions were made, must have been the case), as a result of the Contributions, the state of the Company’s stock changed in the sense that the amount of funds distributable with respect to the Shares as a dividend or upon liquidation was increased by the amount of the Contributions.

Under Delaware law, the funds available for payment of dividends, if and when declared by a corporation’s board of directors, are payable out of “surplus.” 8 Del. C. § 170. “Surplus” is defined in relation to “capital.” “Capital” with respect to no par stock, such as the Shares, is defined as that portion of the consideration received by a corporation for the issued shares of its capital stock that the directors determine to be capital, or if no such determination is made, the amount of consideration received. 8 Del. C. § 154. The excess, if any, at any given time, of the net assets of the corporation over the amount so determined to be capital shall be “surplus.” 8 Del. C. § 154. “Net assets” means the amount by which total assets exceed total liabilities. 8 Del. C. § 154. Therefore, the “surplus” of a corporation is an amount equal to the total assets of the corporation, minus the total liabilities of the corporation, minus the capital of corporation, minus the total liabilities of the corporation, minus the capital of the corporation (as just described). Here, the Contributions increased the Company’s net assets, and thus its surplus, thus increasing the amount of funds the Company could lawfully have distributed to the Trustees (as stockholders) as a dividend.

With respect to entitlement to distributions on dissolution, when a corporation dissolves, its assets are held in trust for the benefit of creditors, and if creditors are paid in full, the stockholders. Accordingly, when a corporation dissolves it must first pay or provide for its creditors, both fixed and contingent, in full before any distribution can be made to stockholders. However, once creditors are paid or provided for, any residual assets are to be distributed to the corporation’s stockholders. 8 Del. C. § 281. As described above, the Contributions increased the Company’s total assets. If the Company had been dissolved immediately after such Contributions had been made (which the Trustees, as the sole stockholders, could have done pursuant to Section 275(c) of the General Corporation Law, 8 Del. C. § 275(c), then the amounts the Trustees (as stockholders) would have been entitled to receive as stockholders upon dissolution with respect to the Shares would be increased by the amount of the Contributions assuming, in each case,

that amounts would remain for distribution to the stockholders following the payment in full of the Company's creditors.

Therefore, the Contributions would have increased the amounts that could have been distributed with respect to the Shares either as a dividend or as a liquidating distribution.”

10. The Trustees, as already noted, acquired the shares for \$1,000 in 1983. The first Consolidated Balance Sheet as at 5 April 1984 shows a surplus of assets over liabilities of \$1,470,687 (of which \$1,190,250 is attributable to the Capital Contributions). The Balance Sheet as at 31 March 1985 shows a surplus of \$1,678,782 (of which \$1,662,000 is attributable to all Capital Contributions made to that date). The Balance Sheet as at 31 March 1986 shows a surplus of \$1,929,502 (of which \$1,909,625 is attributable to Capital Contributions made up to that date). The Balance Sheet as at 31 March 1987 shows a surplus of \$2,390,246 (of which \$2,192,125 is attributable to Capital Contributions made up to that date). We were not provided with later accounts.
11. The business of Daviebrook subsequently failed. By agreement of 31 March 1994 the Trustees sold the entire share capital of Daviebrook (still 1,000 shares) for \$1.

The legislation

12. TCGA 1992 section 38(1)(b) provides:

“(1) Except as otherwise provided, the sums allowable as a deduction from the consideration in the computation of the gain accruing to a person on the disposal of an asset shall be restricted to –

...

(b) the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal ...”

The Opposing Contentions

13. The Trustees contend that, in computing for the quantum of their allowable losses, the £1,530,546 paid in to Daviebrook as Capital Contributions should be deducted as expenditure within the terms of section 38(1)(b). On this basis, the Trust would have no capital gains tax liability for 1997/98, as allowable losses so computed would exceed chargeable gains for that year.
14. By contrast, the Revenue contends that the quantum of allowable losses arising from the disposal of the shares must be limited to the original

acquisition cost of the shares, namely £661, (being \$1000 at the relevant exchange rate) pursuant to section 38(1)(a).

Conclusions

15. Two related questions arise. First, what if any expenditure have the Trustees incurred “on the asset ... for the purposes of enhancing the value of the asset”? Second, given that expenditure has been so incurred, was it “expenditure reflected in the state or nature of the asset at the time of the disposal” in March 1994?
16. The “asset” is the shares. The shares represent the interest in Daviebrook of the Trustees as members of Daviebrook. That interest is made up of the mutual covenants contained in the “constitution” of the company and the number of shares issued to the Trustees is the measure of their interest in Daviebrook.
17. The consequence of each Capital Contribution was to increase the net assets of Daviebrook, and therefore the “surplus” that was available for stockholders – either as a dividend (should the company choose to pay them) or as a distribution on the liquidation of the company. The enhancement effect is demonstrated by the increases in the surplus resulting from the Capital Contributions as shown in the accounts and set out in paragraph 10 above.
18. With those points in mind we now address the issues. Is the amount provided by the Trustees expenditure “on” the assets as determined? The Revenue argue that it is not. There were, they point out, no additional shares issued as a result of the contribution nor were there any additional rights etc. attached to the shares as a result of the contributions made. We accept that no new shares are issued when the particular Capital Contribution is made. Nonetheless, each Capital Contribution results in an increase in the stockholders’ equity shown in the accounts (as additional paid-in capital). Bearing in mind Riberiro PJ’s useful statement in *Collector of Stamp Revenue v Arrowtown Assets Ltd*, (which was quoted with approval by Lord Nicholls in *Barclays Mercantile Business Finance Ltd v Mawson* [2004] HL 51):

“The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.”,

we consider that the capital contributions should be considered to be expenditure “on” the shares in Daviebrook for the purposes of section 38(1)(b).

19. That the expenditure in question, i.e. the Capital Contribution, is incurred by the Trustees, as members, for the purpose of enhancing the value of their assets is, we think, self-evident. As observed already the amount contributed actually enhances the value of the asset. The irresistible inference must be that the Trustees, as members, incurred the expenditure with that purpose in mind.

20. Was the expenditure reflected in the state or nature of the asset at the time of disposal? The Appellants' submit that the fact that the shares are more valuable immediately after the Capital Contributions (because of the consequential increase in the company's surplus) means that the expenditure on the contributions was reflected in the state and nature of the shares at that time (and would continue to be reflected in the state and nature of the shares – notwithstanding the subsequent decline in the company's fortunes – until the company is eventually dissolved). The Appellants acknowledge that no additional shares were issued as a result of the Capital Contribution and that the rights and restrictions attaching to the shares remain unchanged. They submit that the fact that the "surplus" available for distribution to stockholders has been increased is sufficient to satisfy this requirement.
21. The Appellants support this with the arguments that follow. First, they submit that to decide otherwise would lead to results which are contrary to common sense – in Lord Wilberforce's words in *Aberdeen Construction Group Limited v Commissioners of Inland Revenue* (1978) 52 TC 281 at 296G "the courts should hesitate before accepting results which are paradoxical and contrary to business sense". Secondly, if section 38(1)(b) did not apply in these circumstances, then it is difficult to envisage any circumstances to which these provisions might apply – at least as regards intangible assets – and the draughtsman would not have created a provision which could never be applied. Thirdly, had Daviebrook issued but one share, then either as a consequence of the "pooling" provisions then in force under section 104 TCGA, or under the reorganisation provisions under section 128, then the expenditure would have been allowable for the purpose of computing the gain.
22. We agree with Mr Goldberg that not to allow the Capital Contributions as expenditure within section 38(1)(b) does lead to circumstances that are anomalous – but anomalies can arise – particularly at the intersection of different legal systems. Although capital contributions are not unknown to English law (see for example *Kellar v Williams* [2000] 2 BCLC 390), they are unusual, whereas we understand they are a common method for Delaware companies to raise additional capital. Although the Capital Contributions may have led to an increase in the "surplus" of Daviebrook as a matter of Delaware law, we do not consider that an increase in the surplus is sufficient for the expenditure to be "reflected in the state or nature" of the shares either at the time the expenditure was incurred, or at the time of the disposal.
23. It is clear from the provision that Parliament did not intend that all expenditure incurred for the purpose of enhancing the value of an asset should be deductible in computing capital gains. Only such expenditure as would be reflected in the "state and nature of the asset at the time of the disposal" was to be allowed. Further, "state and nature" for these purposes must be something other than merely the value of the asset – otherwise this phrase would add nothing to the immediately preceding words. In this case the Capital

Contributions did not result in any increase in the number of shares in issue, or result in any change in the rights or restrictions attaching to the shares. The only effect of the Capital Contributions was to increase the surplus of the company – which would increase the amount available for distribution to shareholders, and therefore presumably the value of the shares. We do not consider this sufficient for the expenditure on the Capital Contributions to be reflected in the state and nature of the shares, either at the time the expenditure was incurred or at any time subsequently.

24. We agree that the expenditure on the Capital Contributions would have been allowable had the company issued even one share – either under the then “pooling” provisions in section 104, or under the reorganisation provisions (in particular section 128). We also acknowledge that it is likely that the issue of one share could have been effected quite informally. However no such share was ever issued. The fact that US federal tax law might regard a share as having been issued in some circumstances for certain US federal income tax purposes, even if, as a matter of fact, no such share was ever issued (see *Lessinger v Commissioner of Internal Revenue* 85 TC 824 (US Tax Court)) is irrelevant to the application of UK tax law to this case.
25. We also consider as irrelevant that section 38(1)(b) might have no application to intangible assets if it has no application in the facts of this case. It is clear that the provisions have application in relation to land and buildings (for example expenditure on the construction of a new house on an empty plot), and the provisions are therefore not without meaning.
26. It follows from the conclusions reached above that we do not regard the Capital Contributions as being allowable expenditure for the purposes of section 38(1)(b), Taxation of Chargeable Gains Act 1992, and we therefore dismiss the appeal.