

HOUSE OF LORDS

OPINIONS OF THE LORDS OF APPEAL FOR JUDGMENT IN THE CAUSE

ROBERT WALKER
(HM INSPECTOR OF TAXES)

Respondent

- v -

CENTAUR CLOTHES GROUP LIMITED

Appellants

BEFORE:

LORD SLYNN OF HADLEY

LORD NOLAN

LORD NICHOLLS OF BIRKENHEAD

LORD HOFFMANN

LORD CLYDE

Mr David Goldberg QC and Mr Conrad McDonnell (instructed by Legal Department, William Baird plc) on behalf of the Appellant

Mr Nicholas Warren QC and Mr Michael Furness (instructed by The Solicitor for the Inland Revenue) on behalf of the Respondent

Judgment: 6 April 2000

Lord Slynn of Hadley:

My Lords,

I have had the advantage of reading in draft the speech prepared by my noble and learned friend Lord Hoffmann. For the reasons he gives I would allow the appeal.

Lord Nolan:

My Lords,

I have had the advantage of reading in draft the speech of my noble and learned friend Lord Hoffmann. I agree that, for the reasons he gives, this appeal should be allowed.

Lord Nicholls of Birkenhead:

My Lords,

I have had the advantage of reading in draft the speech of my noble and learned friend Lord Hoffmann. I agree that, for the reasons he gives this appeal should be allowed.

Lord Hoffmann:

My Lords,

Centaur Clothes Group Limited ("Centaur"), is a company in the William Baird group which traded in men's clothing. On 6 January 1992 it ceased trading and sold its assets and undertaking to another company in the group called Baird Textile Holdings Ltd ("Baird Textiles"). The price of £4,290,242, was left outstanding, payable on demand without interest. It also agreed to carry on its former business as unpaid agent for Baird Textiles. These arrangements might have been unusual between parties at arms' length but made perfectly good sense within the group.

On 5 April 1993 Centaur declared a dividend of £2,087,113 out of accumulated profits. The payment created a liability under section 14 of the Income and Corporation Taxes Act 1988 (as it then stood) to advance corporation tax ("ACT"). So Baird Textiles paid £695,704.10 to the Inland Revenue on behalf of Centaur. On 8 December 1993 Centaur declared another dividend which resulted in a further payment of £265,645.16 by way of ACT.

ACT, which was abolished by section 31 of the Finance Act 1998 with effect from 6 April 1999, was corporation tax charged by reference to the amount of a distribution rather than profits. It was chargeable "in advance" because ordinarily it could afterwards be set off against the company's liability to corporation tax charged upon its profits. Section 239(1) of the Act of 1988 provided that a company which had paid ACT in an accounting period could set off the payment against its assessed liability to corporation tax in that accounting period. This was no use to Centaur: its accounting period had come to an end on 6 January 1992 when it ceased to trade (see section 12(3)(c)) and it had not subsequently earned any profit. But section 239(3) allowed

the benefit of the payment of ACT to be carried back and set off against the company's corporation tax liabilities for earlier years. The relevant words read:

"Where in the case of any accounting period of a company there is an amount of surplus advance corporation tax, the company may, within two years after the end of that period, claim to have the whole or any part of that amount treated for the purpose of this section ... as if it were advance corporation tax paid in respect of distributions made by the company in any of its accounting periods beginning in the six years preceding that period ... and corporation tax shall, so far as may be required, be repaid accordingly."

"Surplus" ACT was defined, in relation to any accounting period, as ACT which could not be set against the company's liability to corporation tax because the company had no profits for that period. Centaur therefore made a claim to have the two 1993 payments of ACT set off against the corporation tax paid in earlier years, when it had been carrying on business, and asked for the appropriate refund.

The revenue refused the claim for the first dividend but accepted the claim for the second. This may seem rather odd. The reason given was that section 239(3) allows surplus ACT "in any accounting period" to be carried back. At the time when Centaur paid the first dividend, said the revenue, it had no accounting period. Section 12 specifies when, for the purposes of corporation tax, accounting periods begin and end. By section 12(3)(c), as I have already mentioned, an accounting period ended on 6 January 1992. By section 12(2)(b), if the company remains "within the charge to corporation tax" a new accounting period will begin at once. If the company ceases to be within the charge, a new accounting period will begin (under section 12(2)(a)) only when the company again comes within it: "whether by the company becoming resident in the United Kingdom or acquiring a source of income, or otherwise". But the revenue contend that the effect of the cessation of trade and the arrangements for transfer of the assets and undertaking to Baird Textiles was that Centaur ceased to be within the charge to corporation tax and was still not within the charge when it became liable to pay corporation tax on the first dividend. Therefore it had no accounting period and the payment of ACT has disappeared into a black hole from which no set-off can ever be extracted.

The reason for the paradox by which a company can be liable to pay corporation tax without being within the charge to that tax is, say the revenue, that "within the charge to corporation tax" is not an expression which can be construed by the light of nature. Section 832(1), the definition section, gives it a narrow and specialised meaning. The definition reads:

"a source of income is within the charge to corporation tax or income tax if that tax is chargeable on the income arising from it, or would be so chargeable if there were any such income, and references to a person, or to income, being within the charge to tax, shall be similarly construed."

The revenue argue that "similarly construed" means that the definition must, so to

speak, be read cumulatively. A source of income is within one or other tax if the income is, or would be, liable to that tax. Income is within the charge to a tax if it is from a source within the charge to that tax and a person is within the charge to a tax if he had a source of income within the charge to that tax. In the case of Centaur, the arrangements under which it transferred its assets and undertaking to Baird Textiles left it with no sources of income whatever. The outstanding debt carried no interest and the agency contract carried no remuneration. Therefore it was not within the charge to corporation tax.

After payment of the first dividend Centaur seems to have learned about the revenue's views on the matter and took the precaution of obtaining £2,000 from within the group, which on 30 September 1993 it placed in an interest-bearing deposit account at a bank. By the end of the year it had yielded £8 in interest. This was enough to satisfy the revenue. The company had acquired a source of income chargeable to corporation tax. A new accounting period had therefore begun. This allowed Centaur to recover the £265,645.16 ACT paid on 8 December 1993.

The special commissioners (Mr Paul W de Voil) said [1996] STC (SCD) 222, 226 that the revenue's submission was contrary to common sense:

"On the revenue's argument, Centaur is to be repaid £265,000 because it had received a tiny amount of bank interest at the right time, and refused payment on an entirely similar £695,000 because it had not received a tiny amount of bank interest at the right time."

On appeal, Sir John Vinelott [1997] STC 72 agreed that the result was "paradoxical" and "arbitrary" but held that it was inescapable. It was the natural meaning of the definition, which was not fairly capable of being given a different construction. The problem arose because when ACT was introduced by the Finance Act 1972 it was "bolted on" to an existing structure of corporation tax going back to the Finance Act 1965 without regard to some of the difficulties which might arise. He allowed the revenue's appeal. The Court of Appeal, (Nourse and Peter Gibson LJJ and Sir Patrick Russell) [1998] STC 814, in a judgment given by Peter Gibson LJ affirmed his decision.

My Lords, I can find nothing in the language of the definition which requires the concept of "income" being within the charge to corporation tax to be restricted to income derived from a source within that charge. Still less is there reason to restrict the concept of a person being within that charge to persons having a source of income within that charge. The definition of a source of income within the charge to income tax or corporation tax is hardly technical or sophisticated. It says that a source is within the charge to income tax. And likewise for corporation tax. How does one give a similar construction to "income" and "a person?" I should have thought the answer was not difficult. Income is within the charge to income tax if it is liable to income tax and within the charge to corporation tax if it is liable to corporation tax. And a person is within the charge to income tax if he is liable to pay income tax and within the charge to corporation tax if he is liable to pay corporation tax. I shall in due course consider the implications of this construction, but for the moment it will do.

It is true that by section 9(3), the computation of income for the purposes of corporation tax is to be computed according to income tax principles and under the same Schedules and Cases. Income tax is traditionally a source-based annual tax, liability depending upon the existence of a source of income falling under one of the Schedules during the year of assessment: *Brown v. National Provident Institution* [1921] 2 AC 222. If the income tax had retained that ancient simplicity, it would be true to say that income could not be within the charge to tax unless there was a source within the charge and a person could not be within the charge unless he had a source of income within the charge. But that would be because of the nature of the income tax and not anything in the language of the definition.

It is however no longer true to say that liability to income tax depends upon the existence during the year of assessment of a source within the charge. There are cases (such as post-cessation receipts) when liability depends upon the existence of income defined by reference to a source which does not exist within the year of assessment. Or liability may depend upon an event, such as a balancing charge on the sale of an asset which has attracted a capital allowance, or the receipt of a capital sum from a particular kind of transaction, which is deemed to be taxable income received in that year of assessment or sometimes spread over several years of assessment. In the case of corporation tax, liability is also imposed upon chargeable gains. So there is no longer any basis for assuming that income, or a person, can only be within the charge to corporation tax in a given year of assessment if the income is from or the person has a source of income within the charge to that tax.

My Lords, one could give many examples of the strange consequences which would follow from the revenue's narrow construction of a "person within the charge to corporation tax". I shall give one, wholly removed from the present facts. By section 524(1) of the Act of 1988, a UK resident company which sells patent rights for a capital sum is chargeable to corporation tax as if that sum were income chargeable under Case VI of Schedule D and spread over 6 years. By section 256 the company is entitled to an allowance for expenses incurred in connection with the grant or extension of the term of the patent. By section 528(3)(b), if the allowance cannot be given full effect in an accounting period because there is not enough income or deemed income, the surplus may be carried forward to subsequent accounting periods "as long as the company remains within the charge to corporation tax".

What then, is the position of a company which has no business and no assets except a patent on which it has incurred expense and which it sells for a capital sum? If the deemed income in the first year after the sale is not enough to exhaust the allowance for expenses, can it be carried forward? In the subsequent years, the company has no assets except the proceeds of sale, which may (as in this case) not be a source of income. Is it "within the charge to corporation tax"? My Lords, in my opinion it plainly is. It has deemed income which is assessable to corporation tax. It would seem to me extraordinary if it could not set off its expenses against that liability.

If one asks why the legislature was particularly concerned with the question of whether a given source of income was within the charge to income tax or corporation tax. I think that the principal reason will be found in the transitional provisions of the Finance Act 1965. Corporation tax replaced income tax and capital gains tax over a period from 6 April 1964 to 5 April 1966. In the case of income. the transition was by

reference to sources and depended upon when the source was acquired or ceased and the company's accounting periods in respect of income from that source. So a company could have some income still within the charge to income tax and some already within the charge to corporation tax and it was necessary to distinguish the two. The transition from capital gains tax to corporation tax occurred in the year 1965-1966 when the company (if it had not done so before) came within the charge to corporation tax "in respect of any source of income or part of a source": see section 82(1) of the Act of 1965.

On the other hand, the concept of being "within the charge" to a tax is also used in contexts in which the source is irrelevant or non-existent. I have given one example and counsel gave others with which I shall not trouble your Lordships. In such cases, if I may expand upon the simple construction which I gave earlier. I would say that income is "within the charge" to corporation tax if it is derived from a source within that charge or is liable to corporation tax under some provision which makes it taxable without the existence of such a source. Likewise, a company is within the charge to corporation tax if it is or would be liable to pay corporation tax on a source of income within the charge or it has income which is chargeable irrespective of source or it has realised chargeable gains or allowable losses or because some other event has occurred which creates a liability to pay the tax.

My Lords, if this analysis is correct, then the revenue are right in saying that Centaur ceased to be within the charge to corporation tax when it disposed of its assets and undertaking on 6 January 1992. Thereafter it had no source of income within the charge and no income or chargeable gains within the charge. Nor did any event occur to bring it within the charge until it made the first distribution on 5 April 1993. But then it came within the charge and under section 12(2)(a) a new accounting period began. The subsection reads:

"An accounting period of a company shall begin for purposes of corporation tax whenever... (a) the company, not then being within the charge to corporation tax, comes within it, whether by the company becoming resident in the United Kingdom or acquiring a source of income, or otherwise; ..."

The relevant words are "or otherwise". The subsection plainly contemplates that a company which was not within the charge and has not acquired a source of income can in some other way come within the charge. In my opinion, this covers any case in which something happens to create a liability to pay corporation tax. The accounting period may be a very short one if there is nothing else to keep the company within the charge. But it is an accounting period nevertheless.

Mr Warren, who appeared for the revenue, said that the objection to this construction was that it would make section 12(6) unnecessary. The subsection provides that:

If a chargeable gain or allowable loss accrues to a company at a time not otherwise within an accounting period of the company, an accounting period of the company shall then begin for the purposes of corporation tax, and the gain or loss shall accrue in that

accounting period.

If an event creating a liability to pay corporation tax brings a company within the charge, then the realisation of a chargeable gain would start a new accounting period even without section 12(6). So the subsection would be redundant.

My Lords, I seldom think that an argument from redundancy carries great weight, even in a Finance Act. It is not unusual for Parliament to say expressly what the courts would have inferred anyway. As it happens, there was no provision corresponding to section 12(6) in the original scheme of corporation tax in the Finance Act 1965. It was introduced as a second thought by section 27 and para. 12(2) of Schedule 5 to the Finance Act 1966. And it also provides for the commencement of an accounting period when the event has not created a chargeable gain but has resulted in an allowable loss. I can see why the draftsman might have thought that an event which created no liability to corporation tax but could affect liability in respect of other profits or gains was not something which brought the company within the charge to tax.

My Lords, a conclusion that a company which is liable to pay corporation tax is within the charge to corporation tax seems to me to be in accordance with the common sense which appealed to the special commissioner. It would be an extraordinary case of the tail wagging the dog if the provisions about accounting periods, which are mere machinery, could destroy the substantive right to recover the tax. In the Court of Appeal, Peter Gibson LJ noted, [1998] STC 814, 821, that counsel for the revenue had not put forward any “discernible legislative purpose” in denying the recovery of ACT and said at p.825, that he reached his conclusion “with considerable unease”. That is usually a symptom of something having gone wrong, either with the legislative process or with the way the arguments have been presented. In this case I think that the arguments have been unnecessarily complicated in two ways. The first has been by an attempt to read the words “similarly construed” in section 832(1) as requiring a Procrustean insertion of the words “income” and “person” into the definition of “source of income within the charge”. In my view, all that is required is a construction according to the same simple principle. The second has been the attempt by counsel for the taxpayer to construe “within the charge to corporation tax” as embracing every company which could, upon the remotest contingency, become liable to pay the tax. This provoked Mr Warren to construct ever more elaborate examples of companies which would, on the most fanciful grounds, be “within the charge”. In most such cases the question of whether the company was within the charge would be entirely academic because the question is only relevant when something happens which would affect the company’s liability to tax. But in my view these speculations are sterile and unnecessary. I think that when Centaur became liable to pay ACT it was by definition within the charge to tax and therefore had an accounting period. I would allow the appeal and restore the decision of the special commissioner.

Lord Clyde:

My Lords,

I have had the advantage of reading in draft the speech prepared of my noble and learned friend Lord Hoffmann. I agree that, for the reasons he gives, this appeal should be allowed.