

Disposal proceeds or interest?



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A client company is dealing with a sale of shares and it is expected that the gain on the disposal will qualify for the substantial shareholding exemption. Completion of the contract has been delayed for several months and a considerable amount of 'interest' has effectively been added to the basic consideration for the sale of the shares. My client wonders whether this 'interest' will be subject to corporation tax under the loan relationship rules, or whether it will form part of the consideration for the sale of the shares.

For both capital gains tax and corporation tax purposes, a gain is computed by reference to the excess of the disposal proceeds over the acquisition costs for an asset. In a case where part of the proceeds are described as 'interest' the question arises as to how this part of the proceeds should be treated for tax purposes.

Case law

The concept of interest being used merely as part of a formula to arrive at a price or at an amount of compensation, rather than being true interest, arises in *Westminster Bank Ltd v Riches* (1945) 26 TC 159. In this case, Lord Wright observed: 'the essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had the use of the money, or, conversely the loss he suffered because he had not had that use. The general idea is that he is entitled to compensation for the deprivation.'

The leading case on the meaning of 'interest of money' is *Re Euro Ltd Hotel (Belgravia) Ltd* (1975) 51 TC 293. In that case a bank (K) acquired rights under a building agreement from another company (E). E was required to make payments, described as 'interest' to K. It did not withhold tax from the payments. Subsequently K took winding-up proceedings against E for arrears of rent, and E lodged a counterclaim that it should have withheld tax from the payments of 'interest' to K under what is now ITA 2007 s 874, so that there were no grounds for the petition. It was held that the payments were not 'yearly interest of money'. Megarry J held that, for a payment to amount to 'interest of money', there

must be a sum of money, due to the person entitled to receive the interest 'by reference to which the payment which is said to be interest is to be ascertained'. The sums by reference to which the payments here were ascertained were units of calculation, rather than loans due to K. The payments were not interest on loans but were compensation for E's 'delay in performance of other obligations'.

From these two cases we can identify two requirements to be satisfied for a payment to amount to interest:

- There must be a sum of money by reference to which the payment which is said to be interest is to be ascertained: a payment cannot be 'interest of money' unless there is the requisite 'money' for the payment to be said to be 'interest of'.
- Those sums of money must be due to the person entitled to the alleged interest.

What constitutes interest is a question of legal substance, not terminology. In the *Westminster Bank* case, Lord Wright said its 'essential quality ... depends on substance not on the mere name'. Lord Simonds, with Lord Parker concurring, said that what needed to be considered was 'what is its intrinsic character'.

That substantive test was reaffirmed in *Re Euro Hotel (Belgravia) Ltd*, in which Megarry J said: 'it has, quite rightly, not been suggested that the language used by the parties to an instrument in describing payments to be made under it can bind the Inland Revenue, or affect the operation of a statute. The question must always be one of the true nature of the payment.'

The contract in that case was one in which it was provided that one party would 'pay to the bank interest'. It was held that what was paid was not 'interest of money' despite the wording of the

contract quoted above, because the bank in question had not advanced money as a loan, but instead as out and out non-returnable payments for building works. The 'interest' was not 'interest of money'.

HMRC manuals

HMRC confirms at para CFM31030 of its *Corporate Finance Manual* that a debt exists where one party has a legal obligation to transfer cash, goods or services to another. If the creditor has no legal right to the consideration, there is no debt. Where a company contracts for the purchase of plant and machinery and the completion date is not until the following week there is no legal right to payment until completion. Accordingly, a debt only comes into existence if payment remains outstanding at the completion date.

If a debt comes into existence on the completion of a contract for a sale of shares, then any amounts calculated up to the date of completion ... will not be 'interest of money' but additional consideration

Conclusion

On the basis that a debt comes into existence on the completion of a contract for a sale of shares, then any amounts calculated up to the date of completion which are described as 'interest' will not be 'interest of money' but additional consideration which may qualify for the substantial shareholding exemption. This follows the case law set out in the two cases mentioned above. ■



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