68TACD2021

Between/

[redacted]

Appellant

-and-

THE REVENUE COMMISSIONERS

Respondent

DETERMINATION

A. Matter under Appeal

1. This matter comes before the Tax Appeals Commission as an appeal against the Respondent's decision of the 4th of May 2016 where it refused to allow the Appellant's claim under s.538(2) of the Taxes Consolidation Act 1997 as amended (hereinafter "**TCA 1997**") for a loss made on a loan as a consequence of it having been disposed of at negligible value.

B. ***Facts relevant to the Appeal***

2. The Appellant was the holder of [redacted] €0.01 shares in [redacted] Limited, which was at the times material to this appeal the holding company of a French-registered entity, the sole asset of which at the time of the disposal at issue in this appeal was a hotel located in [redacted] in France. The date of registration of [redacted] Ltd was the [redacted] of September 2007.

3. On or about the 1st of October 2007, pursuant to a loan agreement of the same date, the Appellant advanced the sum of €649,928.57 to [redacted] Ltd. Under clause 2 of the aforesaid loan agreement, the sum in question was to be repaid by [redacted] Ltd within a period of ten years.

4. Clause 4 of the loan agreement was headed "*Conversion*" and governed the right of the Appellant to convert the loan into shares in [redacted] Ltd. The true construction of this term of the agreement is central to the determination of this appeal.

5. Clause 4(a), headed *"Conversion Right"*, provided that:-

   "At any time before repayment of the Loan, the Lender may, by notice in writing to the Borrower (a "Conversion Notice"), require the Borrower, in accordance with this clause 4, to convert the Loan into such number of Relevant Shares as is obtained by dividing the aggregate amount of the Loan (together with accrued interest thereon) by the Conversion Price on the terms of and subject to the conditions set out in this Clause 4."

6. Clause 4(b), headed *"Election Date"*, provided that:-

> *"Within seven business days of the day of the Conversion Notice the Borrower shall irrevocably elect by notice in writing to the Lender to: Allot and issue to the Lender Relevant Shares, credited as fully paid, to which the Lender shall be entitled pursuant to the provisions of the clause 4.1 and shall, immediately thereafter, enter or procure the entry of the name of the Lender in the register of members of the Borrower in respect of such relevant Shares and shall deliver to the Lender share certificates in respect of such Relevant Shares."*

7. I note in passing at this stage that the reference to *"clause 4.1"* above appears to be a reference to the Appellant's right of conversion under the aforesaid clause 4(a). I do not find this apparent error to be material to the issues in this appeal.

8. Clause 4(d), headed *"Maintenance of Capital"*, provided that [redacted] Ltd would:-

> *"…procure that it shall have available for use a sufficient number of authorised but unissued Relevant shares in its authorised capital to satisfy exercise of the conversion rights hereunder if and when the Lender becomes entitled to exercise such rights".*

9. Article 10 of the Articles of Association of [redacted] Ltd, dated the [redacted] of September 2007, which was headed "Transfer of Shares", provided that:-

"The Directors may, in their absolute discretion and without assigning any reason therefor, decline to register any transfer of any share, whether or not it is a fully paid share; and Regulation 22 of Part I of Table A will be modified accordingly."

10. In December 2014, the hotel owned by the French subsidiary of [redacted] Ltd was sold at a loss with the agreement of the mortgagee bank. This rendered the shares in [redacted] Ltd valueless. The shareholders of [redacted] Ltd subsequently agreed to write off loans they had made to the company that had a combined value of €[redacted]. This included the loan at issue in this appeal.

11. On the 4th April 2016 the Appellant made a claim of €649,928.57 for an allowable loss under section 538(2) of TCA 1997 on the grounds that the loan had been disposed of at negligible value.

12. On the 4th of May 2016, the Respondent notified the Appellant that it was refusing to allow the claimed loss. The reason given to the Appellant for the refusal was that under the terms of the loan agreement he did not have an "*automatic right*" to convert the debt to shares in [redacted] Ltd. The significance of this right to the question of whether an allowable loss could be claimed is discussed hereunder in this determination.

13. The Appellant's agents wrote to the Respondent on the 10th of May 2016, asking for a review of this decision on the grounds that he had an absolute right to convert the debt owed to him into shares. The Respondent replied on the 18th of May 2016, stating that it had reviewed Clause 4(a) of the loan agreement and remained of the view that it did not afford an *"...explicit right in favour of your client to convert the loan to securities."*

14. Further correspondence, in which the Appellant repeated his argument that the right to conversion of the debt to shares was one that could be exercised entirely at his discretion, was sent to the Respondent on the 30th of May 2016. The Respondent replied on the 21st of June 2016, which correspondence reiterated the prior refusal and the reasons for it and informed the Appellant that he had the right to appeal to this body.

15. This appeal under section 949 of TCA 1997 proceeded by way of oral hearing before me. I heard evidence from the Appellant and legal submissions from both parties in the course of the hearing. In addition, I had the benefit of written submissions lodged by both parties in the form of their respective Statements of Case.

C. ***Relevant Legislation***

16. The parties were agreed about the legislation relevant to this appeal.

17. Part 19 of TCA 1997 contains provisions relating to the taxation of chargeable gains for the purposes of Capital Gain Tax. Chapter 1 therein concerns assets, their acquisition and their disposal.

18. Section 532 of TCA 1997 provides that:-

"All forms of property shall be assets for the purposes of the Capital Gains Tax Acts whether situated in the State or not, including—
(a) options, debts and incorporeal property generally..."

19. Section 538 of TCA 1997 is entitled *"Disposals where assets lost or destroyed or become of negligible value".* The subsections of this provision relevant to the issue in this appeal provide as follows:-

"(1) Subject to the Capital Gains Tax Acts and in particular to section 540, the occasion of the entire loss, destruction, dissipation or extinction of an asset shall for the purposes of those Acts constitute a disposal of the asset whether or not any capital sum as compensation or otherwise is received in respect of the destruction, dissipation or extinction of the asset.

(2) Where on a claim by the owner of an asset the inspector is satisfied that the value of an asset has become negligible, the inspector may allow the claim, and thereupon the Capital Gains Tax Acts shall apply as if the claimant had sold and immediately reacquired the asset for a consideration of an amount equal to the value specified in the claim."

20. Section 541 of TCA 1997 is entitled *"debts"* and subsection (1) thereof provides that:-

"(a) For the purposes of the Capital Gains Tax Acts but subject to paragraph (b), where a person incurs a debt to another person (being the original creditor), whether in the currency of the State or in some other currency, no

chargeable gain shall accrue to that creditor or to that creditor's personal representative or legatee on a disposal of the debt.

(b) Paragraph (a) shall not apply in the case of a debt on a security within the meaning of s.585."

21. Chapter 2 of Part 19 of TCA 1997 is entitled "*Computation of chargeable gains and allowable losses".* Section 546 therein concerns *"Allowable losses"* and the relevant subsections therein provide that:-

"(1) Where under the Capital Gains Tax Acts an asset is not a chargeable asset, no allowable loss shall accrue on its disposal.

(2)Except where otherwise expressly provided, the amount of a loss accruing on a disposal of an asset shall be computed in the same way as the amount of a gain accruing on a disposal is computed."

22. Section 585(1) of TCA 1997 provides that:-

"In this section –

"conversion of securities includes –

(a) a conversion of securities of a company into shares in the company,

(b) a conversion at the option of the holder of the securities converted as an alternative to the redemption of those securities for cash where the conversion takes place before 4 December 2002, or where the conversion takes place after that date pursuant to a binding written agreement made before that date, and

(c) any exchange of securities effected in pursuance of any enactment which provides for the compulsory acquisition of any shares or securities and the issue of securities or other securities instead;

...

"security" includes any loan stock or similar security, whether of any government or of any public or local authority or of any company and whether secured or unsecured but excluding securities within section 607."

D. Submissions of the Appellant

23. The Appellant submits that the loan advanced to [redacted] Ltd was an asset for the purposes of capital gains tax in respect of which he made an allowable loss upon its disposal.

24. He submits that, in accordance with section 538(1) of TCA 1997, the disposal occurred on the occasion of the sale by the French subsidiary of the hotel in [redacted], as this event rendered the [redacted] Ltd shares, in respect of which he had a right of conversion, of negligible value.

25. He further submits that a debt is defined as an asset under section 532 of TCA 1997. While this is subject to section 541, which provides that no chargeable gain shall accrue to an original creditor who disposes of a loan, s.541(1)(b) makes clear that this exception does not apply to a debt on securities within the meaning of section 585. He submits that the loan he made to [redacted] Ltd was such a debt on securities.

26. The Appellant further submitted that the loan agreement enjoyed a general right of assignability pursuant to the provisions of section 28(6) of the Judicature Act 1877.

27. The Appellant cited in support of his appeal the judgment of Morris J (as he then was) in ***JJ Mooney (Inspector of Taxes) –v- Noel McSweeney*** **[1997] 2 ILRM 429**. The relevant facts in that case were that the major shareholder and director of a company that was in financial difficulty advanced it a cash loan of £140,000.00. A term of this loan was that the shareholder/director had the right to convert the debt owed to him into company stock at a pre-determined price. He never sought to exercise this right and when the company went into liquidation he suffered the total loss of the sum loaned. When, subsequently, the shareholder/director made a profit on a separate transaction in respect of which capital gains tax was assessed, he sought to claim an allowable loss, which was refused by the Revenue Commissioners. The matter came before the High Court by way of a Case Stated from the Circuit Court, and turned on the question of whether the loan was a debt on security and therefore allowable.

28. In the High Court, Morris J noted that under the Capital Gains Tax Act 1975, no chargeable gain could accrue on a simple debt. He observed that the reason for this was that it did not have the potential to increase in value (though of course it could decrease on repayment). Furthermore, as the legislation required that gains and losses under capital gains tax be computed in the same way, no loss could accrue either.

29. This, however, did not apply in respect of a "*debt on security*" by reason of the provisions that are now contained in section 541(1)(a) of TCA 1997. As a consequence, the core question to be answered in ***Mooney –v- McSweeney*** was what constituted such a debt. In answering this question, Morris J first had regard to the view expressed by Lord Wilberforce in ***Ramsay (W.T.) Ltd v IRC* [1982] AC 300** at p329 that such a debt is one *"… with added characteristics such as may enable [it] to be realised or dealt with at a profit"*, or that has *"…such characteristics as enable it to be dealt in and, if necessary, converted into shares or other securities."* Morris J held that there were the elements which identified a debt on a security.

30. This was, in the view of Morris J, entirely logical and it led him to find at paragraph 26 – a passage emphasised in submissions by the Appellant – that:-

> "*The pure loan is exempt from capital gains tax because it can never increase in value. With additional rights to convert it into stock, a debt on a security may appreciate in value and can be marketed at a profit. This is a clear distinction between the two."*

31. Morris J further stated in the subsequent paragraph of his judgment that:-

> *"The essence of a loan on a security must be whether the additional 'bundle of rights' acquired with the granting of the loan, to use Wilberforce L.J.'s phrase, enhances the loan so as to make it marketable and potentially more valuable than the value of the repaid loan upon repayment. This potential increase in value must*

not be illusory or theoretical. It must be realistic at the time when the loan and the rights are acquired by the lender."

32. Applying this to the facts in ***Mooney –v- McSweeney,*** the High Court determined that the loan in question could be characterised as a debt on security on the grounds that the loan could have been offered, complete with the attaching rights and entitlements, for sale. Morris J also found that the fact that the borrowing company was ailing at the time the loan was advanced did not necessarily preclude it being marketable. While difficulty could arise in the search for a buyer, this could be the consequence of *"…local or transient commercial considerations"* that should not be a factor in a court's reasoning.

33. The Appellant relied also on ***Patrick J O'Connell (Inspector of Taxes) –v- Thomas Keleghan,*** **[2001] 2 I.R. 490**. This case concerned a complex commercial transaction in which the shares in a company were purchased from a vendor by way of loan note. The vendor retained a right to convert the loan to shares, but Murphy J, giving the judgment of the Supreme Court, described this right as being "*extremely limited indeed*". Moreover, it was clear from the agreement in question that the loan note was not assignable to any third party. In finding that the vendor was not liable for capital gains tax, as the loan note was not a debt on security, the Court referred to the "*clear guidance*" in ***Mooney –v- McSweeney*** on the definition of such a debt.

34. It is the Appellant's submission that, in accordance with the criteria in *Mooney v McSweeney*, his loan qualified as a debt on security for which he could have been liable for a chargeable gain and, as matters came to pass, he should have been permitted to claim an allowable loss.

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35. In this regard, he repeated the submission made to Revenue in correspondence that the terms of the loan agreement made clear that the right to conversion of the debt to shares was entirely at his election and could not have been resisted by [redacted] Ltd, which had an obligation to allot and issue. He argued that at the time of the agreement, the value of the shares had the potential to rise if the value of the hotel owned by the French subsidiary were to increase. Allied to his freedom to assign the loan, this made the loan advanced to [redacted] Ltd a marketable asset and thus a debt on security pursuant to Morris J's definition in ***Mooney –v- McSweeney****,* subsequently approved by the Supreme Court in ***O'Connell –v- Keleghan****.*

E. __Submissions of the Respondent__

36. In opposition to this appeal, the Respondent submitted that the loan to [redacted] Ltd was a simple debt in respect of which neither a capital gain or a loss could have accrued. It based this on the terms of the loan agreement, which it argued did not afford the Appellant an "automatic or explicit" right to convert the loan to securities.

37. The Respondent also submitted that the loan was not in reality marketable and sought to distinguish ***Mooney –v- McSweeney*** and ***O'Connell –v- Keleghan*** on their facts. The Respondent argued that the ailing company in the former case had obtained funding from financial institutions that was contingent on the shareholder/director providing the loan sum. The willingness of the financial institutions to become involved illustrated, the Respondent submitted, the real commercial potential of the shares in respect which the shareholder/director obtained an absolute right of conversion. It submitted that the finding of Morris J that the loan was a debt on security was "*anchored*" in these facts.

38. The Respondent did not agree that the features of the transaction in ***O'Connell –v- Keleghan*** that qualified it as a simple debt (such as the bar on selling the loan notes to a third party, and the lack of likelihood of a making of a profit) could properly be juxtaposed with those in the Appellant's case. The Supreme Court was considering a complex arrangement which, the Respondent submitted, was not comparable to the Appellant's loan.

39. The Respondent further submitted that the loan write-off of €[redacted] was indicative of the fact that it was improbable that the loan advanced in or about 2007 was a marketable asset with commercial potential. The Respondent submitted that it was reasonable to assume that, the decision to dispose of the loan *"developed over a period of time"* before a final decision to write off the loan was made.

40. Lastly, the Respondent submitted that if the loan had returned a profit, the profit would have been returned to the client as a dividend from the company and thus treated as income received and not a capital gain. This, it submitted, excluded a claim for a capital loss.

F. Analysis and Findings

41. Both parties agreed that the critical issue was whether the loan transaction, pursuant to which the Appellant advanced €649,928.57 to [redacted] Ltd during 2007, was a "*debt on security*" within the meaning of section 585 of TCA 1997. If it was, the Appellant's claim for a loss should have been allowed. If not, the decision of the 4th of May 2016 (reiterated subsequently at various times) should stand.

42. In order to qualify as a debt on security, the Appellant's loan must at the time of the agreement have had, per the definition provided by Morris J in ***Mooney –v- McSweeney***, some additional right attaching to it which gave it the *potential* to increase in value, thereby making it marketable.

43. The Appellant submitted that the right of conversion of the loan to shares had precisely this effect. The Respondent contended that it did not because conversion was not an "automatic" or "explicit" right in the Appellant's favour.

44. Clause 4 of the loan agreement governed conversion. Under subclause (a) therein, the Appellant had the right to convert the loan to shares "[a]*t any time before the repayment of the Loan… by notice in writing the Borrower*". Pursuant to subclause 4(b), [redacted] Ltd undertook that on receipt of a conversion notice from the Appellant it would*"… irrevocably elect by notice in writing to the Lender to* [a]*llot and issue to the Lender the Relevant Shares."* Furthermore, [redacted] Ltd was obliged by clause 4(d) of the loan agreement to maintain sufficient authorised share capital to satisfy the exercise of the Appellant's conversion rights.

45. It is clear to me from the wording of the loan agreement that the conversion of the debt into shares was an option wholly at the discretion of the Appellant, which he could have availed of at any time prior to the repayment of the loan. [redacted] Ltd did not have the ability to block the exercise of this right and it was under an express obligation to ensure that it could provide sufficient shares to satisfy a conversion demand. While the word "*elect*" was used in subclause 4(b), read in the context of the rest of clause 4, and because the word "shall" preceded it, it did not, in my view, confer on [redacted] Ltd the right to refuse to allot and issue shares to the Appellant.

46. In relation to article 10 of the Articles of Association of [redacted] Ltd concerning the transfer of shares, this provision did not limit the Appellant's right of conversion. While, pursuant to this article, the directors of [redacted] Ltd retained the right to decline to register any transfer of any share, any exercise of the right of conversion under the loan agreement was to be effected by the allotment and issue of authorised and unissued share capital in the company.

47. The right conferred on the directors of [redacted] Ltd by article 10 might have limited the Appellant's ability to sell any shares he had acquired following a conversion of his loan. This is, however, in my view, a *"…local or transient commercial consideration"*, to use the words of Morris J, and should not be a material factor in my conclusions in this Determination.

48. As a consequence of the foregoing, I find that the Respondent's determination that the right was not automatic or explicit (communicated in their correspondence to the Appellant of the 18th of May 2016) was in error.

49. This leads me to consider whether the right to the shares of the company had the *potential*, at the time the loan agreement was entered into, to increase the value of the debt such that it would have been marketable.

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50. On this question, I do not agree with the Respondent's submission that the ultimate willingness of the Appellant and [redacted] Ltd's other lenders to write off their loans to the company is indicative of the right to conversion being incapable of adding value when the loan was advanced in October 2007, shortly after the company's registration.

51. As a matter of logic, it does not follow that [redacted] Ltd's borrowings at this time meant it was improbable that its shares would appreciate subsequently. In fact, what I find improbable is that the Appellant would have lent such a substantial sum at all to a newly formed company were there to have been no realistic prospect of him getting a return from his investment. For this reason, it appears likely that the Appellant's incentive was a possible upswing in the fortunes of the company and a rise in the share price. I believe this explains more satisfactorily the inclusion of the conversion term .

52. In my view, the conversion right, allied to the absence of any contractual prohibition on the sale of the debt, added to its value and made it a marketable asset. It is not contested that [redacted] Ltd, through its subsidiary, owned or was about to acquire at the time the of the loan agreement a substantial property in the form of the hotel in [redacted]. In this respect, I note that the loan was advanced in 2007, prior to the global financial crisis and the collapse in value of many properties and investments. Again, I am mindful of the words of Morris J in ***Mooney –v- McSweeney*** that it is not appropriate to assess the level of difficulty that a lender would have encountered in finding a buyer, as this would involve taking into account transient or local considerations. What is relevant in my view is that the shares had the potential to exceed the value of the Appellant's loan and therefore the loan was marketable.

53. I turn finally to address the Respondent's submission that any profit made by the Appellant as a result of conversion would have been returned to him as a dividend taxable as income rather than a capital gain. I do not find this to be relevant because, as ***Mooney –v- McSweeney*** and ***O'Connell –v- Keleghan*** make clear, the question is whether the rights attaching to the loan could have given rise to capital gains tax. The Respondent's hypothesis is that any profit would have been paid out in the form of a dividend. I do not see how this can be said with any degree of certainty. The loan was marketable and there was nothing preventing the Appellant selling the debt to a willing third party.

54. As a consequence of the foregoing, I am satisfied that in law and in fact the loan advanced by the Appellant to [redacted] Ltd was a debt on security within the meaning of section 585 and I so find as a material fact. I am further satisfied and find as a material fact that the Appellant made an allowable loss of €649,928.57 under section 538 when he and the other lenders wrote off their loan to [redacted] Ltd.

G. ***<u>Conclusion</u>***

55. For the reasons outlined above, I find that the Appellant has discharged the burden of proof which rested upon him in this appeal and find that:-

(a) the loan advanced by the Appellant to [redacted] Limited by the loan agreement entered into on the 1st of October 2007 was a debt on security within the meaning of section 585 of the Taxes Consolidation Act 1997; and,

(b) the Appellant made an allowable loss for Capital Gains Tax purposes when the loan to [redacted] Limited was written off.

56. I therefore determine that Respondent's decision of the 4th of May 2016 was incorrect and should be varied accordingly pursuant to section 949AL(1) of the Taxes Consolidation Act 1997.

MARK O'MAHONY
APPEAL COMMISSIONER
8 February 2021