PAYMENTS FOR SHARE CAPITAL AND S.419 ICTA 1988

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The Revenue ("HMRC") has recently argued (in more than one matter) that, where an individual ("A") subscribes for shares in a close company ("the Company") on terms that the subscription price is payable by instalments, a liability arises on the Company under s.419 ICTA 1988 (loans to participators etc). HMRC appears to be arguing that a debt equal to the full amount of the future instalments arises when the shares are issued to A. The point has been the subject of recent discussion in *Taxation*, where views as to the correctness or otherwise of HMRC's position were somewhat mixed. For reasons which follow, there should be no liability under s.419 ICTA 1988 in the circumstances under consideration.

Section 419 ICTA 1988 provides as follows:-

> 419 Loans to participators etc.
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> (1) Subject to the following provisions of this section and section 420, where a close company otherwise than in the ordinary course of a business carried on by it which includes the lending of money, makes any loan or advance to an individual who is a participator in the company, or an associate of a participator, there shall be due from the company, as if it were an amount of corporation tax chargeable on the company for the accounting period in which the loan or advance is made an amount equal to 25 per cent of the loan or advance.

Subsection (2) extends the meaning of loan as follows:-

> (2) For the purposes of this section the cases in which a close company is to be regarded as making a loan to any person include a case where –
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> (a) that person incurs a debt to the close company; .. and then the close company shall be regarded as making a loan of an amount equal to the debt.

On the basis of the typical facts under consideration, the terms of A's subscription would not give rise to a loan or advance by the Company.

Whether or not the Company should be treated, under s.419(2)(a) ICTA 1988, as making a loan to A when he subscribes for the shares in the Company depends upon an analysis of the terms and effect of the terms of the subscription as a matter of general and company law. As a matter of general law, one would expect A to incur a prospective liability for future instalments of subscription price on subscribing for the shares in the Company; but one would expect a debt to arise only once a particular instalment had become due but had not been paid. This analysis is consistent with the circumstance that the Company could not sue in debt until each instalment became due. Company law reinforces the conclusion that there is no debt within the meaning of s.419 ICTA 1988 (even as extended by s.419(2)(a) ICTA 1988) until each instalment for the shares becomes due and payable by A. As a matter of company law, a member of a company is bound to pay the full amount unpaid on his shares, but

unless the terms of issue so provide, he is not bound to pay up at once and is only bound in accordance with the Articles of Association of the Company: s.14 Companies Act 1985 ("CA 1985"). When the liability to pay (under s.14 CA 1985) has matured, the shareholder's liability to the Company matures into a specialty debt. In the case of a liability which arises under a call, the liability does not mature into a debt until the call is made: *Whittaker v. Kershaw* (1890) 45 Ch.D 320 at 326.

In modern practice, the use of calls on shares is not frequently adopted. Instead, terms of issues of shares normally provide that what is outstanding on shares shall be paid by fixed instalments. This method has both financial and commercial conveniences. Strictly, an instalment payable at a fixed date by the terms of issue of a share is not a call, but the Articles of companies usually provide that any sum payable in respect of a subscription for shares at a fixed date shall be deemed to be a call duly made and payable on the date on which it became due; and in the case of non-payment of an instalment, the provisions of the Articles dealing with the consequences of non-payment of a call shall apply (Table A Article 16 and Palmers Company Law 6.202 – "Instalments and Calls"). To the extent that they govern the rights and duties of members, Articles of Association operate as a contract between a member such as A, and a company such as the Company (s.14(1) CA 1985). The effect of Table A Article 16 is to provide, as a matter of the contract between A and the Company, that no debt is incurred by A until calls or instalments (which are treated as calls) become due. Further, where the Company has issued shares on terms that the issue price is to be paid by fixed instalments, it cannot call up the instalments before they are due in reliance on a general power to make calls conferred by the Articles: *Re: Cordova Union Gold Company* [1891] 2 Ch 580. When shares are issued for payment by instalments, the natural inference is that the shares are partly paid to the extent of each instalment, and the treatment of instalments as calls in accordance with Table A Article 16 supports this analysis.

Section 738 CA 1985, however, deals with allotment and payment up of shares as follows:-

> 738. "Allotment" and "paid up"
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> (1) In relation to an allotment of shares in a company, the shares are to be taken for the purposes of this Act to be allotted when a person acquires the unconditional right to be included in the company's register of members in respect of those shares.
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> (2) For the purposes of this Act, a share in a company is deemed paid up (as to its nominal value or any premium on it) in cash, or allotted for cash, if the consideration for the allotment or payment up is cash received by the company, or is a cheque received by it in good faith which the directors have no reason for suspecting will not be paid or is the release of a liability of the company for a liquidated sum, or is an undertaking to pay cash to the company at a future date.
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> (3) In relation to the allotment or payment up of any shares in a company, references in this Act (except sections 89 to 94) to consideration other than cash and to the payment up of shares and premiums on shares otherwise than in cash include the payment of , or any undertaking to pay, cash to any person other than the company.

> (4) For the purposes of determining whether a shares is or is to be allocated for cash, or paid up in cash, "cash" includes foreign currency.

It has been suggested in *Taxation* that s.738 CA 1985 requires the full amount of the subscription price to be recognised at the outset and requires the shares to be treated as fully paid. Section 738 CA 1985 does not, however, require this treatment. Section 738 CA 1985 is an interpretation section of CA 1985 (as part of "Part XXVI – Interpretation") and simply extends the meaning of payment up in cash to include "good" cheques, releases of liabilities of the Company and undertakings to pay cash in future. The distinction between payment in cash and payment otherwise than in cash is material to provisions such as s.103 CA 1985 (dealing with valuation of non-cash consideration before allotment) and s.88 CA 1985 (dealing with returns as to allotments). Section 738 CA 1985 does not refer to "partly paid" or "fully paid" or to the distinction between the two; and it would be logically incorrect to describe shares on which instalments are outstanding as fully paid. On the basis of Table A Article 16, such shares will not even be treated as fully called, and it would, therefore, be irregular to describe them as fully paid. In the circumstances, the s.738 CA 1985 point is something of a red herring in the context of HMRC's arguments concerning s.419 ICTA 1988: and there is no liability under s.419 ICTA 1988 on instalments on shares which have not yet become due.

In addition to the point concerning the time at which a debt arises in the context of shares issued for payment by instalments, there is a further defence to liability under s.419 ICTA 1988, where A is not an existing shareholder at the time at which he subscribes for shares in the Company for payment in instalments. Even if (contrary to the view expressed above), the Company is, by reason of s.419(2)(b) ICTA 1988, to be regarded as making a loan to A when he subscribes for the shares, this is not sufficient for liability under s.419 ICTA 1988. It is necessary for A to be a participator in the Company when it is "regarded as making a loan" to him if liability is to arise under s.419(1) ICTA 1988: "where a close company makes any loan … to an individual who *is* a participator …". The term "participator" is defined in s.417(1) ICTA 1988 as follows:-

> (1) For the purposes of this Part, a "participator" is, in relation to any company, a person having a share or interest in the capital or income of the company and without prejudice to the generality of the preceding words, includes –
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> (a) any person who possesses, or is entitled to acquire, share capital or voting rights in the company;
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> (b) any loan creditor of the company;
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> (c) any person who possesses, or is entitled to acquire, a right to receive or participate in distributions of the company … or any amounts payable by the company … to loan creditors by way of premium on redemption; and
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> (d) any person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for his benefit.

> In this subsection references to being entitled to do anything apply where a person is presently entitled to do it at a future date, or will at a future date be entitled to do it.

In the usual case A will not, when he subscribes for shares in the Company – when the Company might be regarded as having made a loan to him – be a participator within the meaning of subparagraphs (a) to (d) of subsection (1) of s.417 ICTA 1988 above, and, until he has subscribed for shares, he will not be entitled to acquire anything either presently or at a future date. Further, he is not, at the relevant time, "a person having a share or interest in the capital or income of the company" within the general words of s.417(1) ICTA 1988. If (as is not considered to be the case) it is correct that A incurs a debt to the Company on subscription, he incurs that debt by the very act which makes him a participator in the company; and s.419 ICTA 1988 does not apply to a person unless he *is* a participator when the loan is made to him (or debt is incurred by him).

Conclusion

A, who subscribes for shares in the Company, is not at the time at which he subscribes for shares, a participator in the Company; and even if the shares acquired are to be paid for in instalments, A does not incur a debt to the Company at the time of subscription. The terms of A's subscription do not constitute the sort of mischief at which s.419 ICTA 1988 is aimed: it was aimed at preventing existing shareholders extracting funds from a close company in otherwise non-taxable forms. A purposive construction of s.419 ICTA 1988, therefore, reinforces the technical analysis provided above and the conclusion that s.419 ICTA 1988 does not apply in the situations in which HMRC is arguing that it does.