DEDUCTION IN COMPUTING PROFITS - Expenditure wholly and exclusively laid out for the purposes of trade etc - Purpose of expenditure - Dual purpose - Conversion of building society into listed bank - Advisory and other costs - Whether incurred for purposes of subsidiaries' trades - No - Whether incurred partly to release value to members - No - Whether incurred partly to secure merger with another building society - No -Whether incurred partly to make shareholders members - No -Appeal allowed - Income and Corporation Taxes Act 1988 s74(1)(a)

DEDUCTION IN COMPUTING PROFITS - capital or revenue expenditure - Conversion from building society to listed bank - Whether payments for advisory and other services capital or revenue expenditure- Revenue - Whether statutory cash bonuses were capital or revenue expenditure - Capital - Appeal allowed in part - Income and Corporation Taxes Act 1988 s.74(1)(f)

THE SPECIAL COMMISSIONERS

HALIFAX PLC Appellant

- and -

C DAVIDSON

(HM INSPECTOR OF TAXES) Respondent

Special Commissioners: STEPHEN OLIVER QC

DR A N BRICE

Sitting in public in London on 6-9, 13-15 and 17 March 2000

John Gardiner QC and Jonathan Peacock, counsel, instructed by Clifford Chance, solicitors for the Appellant

Nicholas Warren QC and Rabinder Singh, counsel, instructed by the Solicitor of Inland Revenue for the Respondent

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DECISION

1. On 1 June 1997 Halifax plc succeeded to all the "properties, rights and liabilities" (to use the words of the Transfer Agreement) of Halifax Building Society. These covered the core business of mortgage lending in the UK and holding personal deposits and included shares in various operating subsidiaries. Halifax plc had been an existing member of the Halifax Building Society group. Shares in Halifax plc (listed on the London Stock Exchange) were issued to voting members of Halifax Building Society (comprising essentially its mortgage borrowers and its depositors) and staff. Members who were not entitled to shares received "statutory cash bonuses". Until then the core business of making mortgage loans and accepting deposits had been carried on by the Halifax Building Society under the regulatory regime imposed by the Building Societies Acts (BSA) and implemented by the Building Societies Commission. From then on that core business was conducted by Halifax Plc as a bank regulated by the Bank of England.

2. In this decision we use the terms Halifax Building Society (or "the building society" for short), and Halifax plc (or "the plc" for short) where we refer specifically to the activities, rights, liabilities etc of those two entities. Otherwise we use this term "the Halifax" which refers to Halifax Building Society until 1 June 1997 and to Halifax plc thereafter.

3. The costs of conversion, which included statutory cash bonuses of some £14.9 million, amounted in aggregate to some £184.8 million. Deductions have been made for this expenditure in computing the Halifax's profits for tax purposes for the periods in which it was incurred. The Inland Revenue have disallowed the full amount as a deduction on the grounds, firstly, that it was capital expenditure and, secondly, it was not incurred wholly and exclusively for the purposes of the Halifax's trade.

The Halifax has appealed. We have been asked to resolve the issues as matters of principle leaving amounts to be agreed. This appeal is the first of four appeals heard successively. These are -

Woolwich plc v Davidson (SpC 2 0)

Northern Rock plc v Thorpe (SpC 241)

Alliance & Leicester plc v Hamer (SpC 242)

Evidence

4. Documentary evidence included -

Accounts of Halifax Building Society and Halifax Plc for the periods to which this dispute relates.

Notices of assessment

Transfer Document issued to all members in pursuance of requirements of BSA

Transfer Agreement of 20 December 1996

Stock Exchange Listing Particulars

Business Plan dated 26 July 1996 provided for Bank of England and update dated 10 March 1997

Building Societies Commission Guidance Note entitled "Conversion Procedures"

Board minutes, Conversion Committee Minutes and related reports and letters: these will be referred to where relevant

Press releases

Letters of engagement and invoices relating to services provided by lawyers, accountants, merchant banks, public relations advisers and stock brokers

Internal conversion documents

Communications with members and customers etc

Correspondence with Inland Revenue

Sample invoices etc.

5. The following witnesses provided witness statements, attended and gave evidence in person for the Halifax -

(i) H J Foulds, the chairman of the Halifax during the period in which it converted from a building society to a bank. Where Mr Foulds' oral evidence is referred to, it is identified by reference to the day and the page of the transcript (e.g. 5/20).

(ii) Ronald McNeill Paterson FCA gave evidence on the accounting treatment of the costs to which this appeal relates. His qualifications are summarized in paragraph 100 below.

6. Witness statements of witnesses for the Halifax were provided by -

Terence Mathews, a full-time member of the Building Societies Commission until his retirement in 1995.

Christopher Knight, managing director of Deutsche Bank. Deutsche Bank's advisory activities were conducted under the name Deutsche Morgan Grenfell. In March 1996 Deutche Morgan Grenfell was appointed to act as merchant bank to the Halifax in connection with its proposed conversion.

David Walkden, assistant General Manager of the Halifax, Commercial Lending, since 1993. He held the role as Programme Manager co-ordinating the conversion process until November 1997.

7. T C Carne FCA, Advisory Accountant to the Board of Inland Revenue, whose other qualifications are set out in paragraph 101 below, provided a witness statement and gave evidence in person on the accounting treatment of the costs to which this appeal relates.

Introduction to the Issues

8. The first issue is whether the expenditure is excluded from deduction by Income and Corporation Taxes Act 1988 section 74(1)(a) (the Taxes Act) on the grounds that it was not laid out wholly and exclusively for the purposes of the relevant trade. It was not in dispute that Halifax plc succeeded to Halifax Building Society's "trade". The Inland Revenue accept that the trade carried on before conversion was the same as that carried on after conversion. They do not therefore contend that the expenditure is to be excluded from deduction as expenditure of Halifax Building Society on the grounds that it was incurred for the purpose of a different trade, i.e. that of Halifax plc. They accept that the expenditure was incurred for the purposes of the Halifax's trade. Their case is that the expenditure was not incurred exclusively for the purpose of the Halifax's trade because it was incurred for other purposes which were non-trade purposes so far as concerned the Halifax. These other purposes included benefiting the trades of the Halifax's subsidiaries, benefiting its non-trading "holding company" function, securing a merger with the Leeds Permanent Building Society ("the Leeds"), resolving a perceived conflict between the interests of customers who were members and customers who were not and releasing value to members.

9. The case for the Halifax, put shortly, is that the sole purpose of the expenditure was to rid it of the regulatory impediments to the efficient and competitive carrying on of its trade, these impediments being imposed by the Building Societies Commission in pursuance of the BSA. The Halifax could only achieve that by becoming a bank regulated by the Bank of England and this meant converting. Conversion could only be effected if a sufficient number of the

members could be persuaded to vote and a sufficient number of them could be persuaded to vote in favour of conversion. The subsidiaries were separately regulated and it was not part of the purpose to benefit either individual subsidiaries or the Halifax's holding company operation. The first issue is dealt with in paragraphs 45 to 97 below.

10. The second issue is whether the expenditure is to be excluded from deduction by reason of its capital nature, as the Inland Revenue contend. This is dealt with in paragraphs 98 to 207 below. .

The disputed costs

11. The costs which are the subject matter of the present dispute were incurred in the period from 1 January 1996 to 31 December 1998. They related to the steps required to implement the conversion process. The event that triggered the conversion process was the decision in principle of the board of directors of Halifax Building Society on 19 October 1994 to convert at a time in the future to a public limited company regulated as a bank; this was followed on 25 November 1994 by a Press Release of the Halifax and the Leeds Permanent Building Society ("the Leeds") announcing that they intended to merge and subsequently to convert to a Plc. The conversion was achieved under section 97 of BSA 1986.

12. The costs were incurred in six main areas:

(i) Corporate finance : This involved preparation of business plans to meet Bank of England requirements for Banking Act 1987 authorization and the preparation of the application for authorization. "Due diligence" work was carried out by KPMG. Share rights of members had to be calculated. A suitable capital structure following flotation had to be prepared and other associated tasks had to be completed..

(ii) Legal and regulatory : This involved satisfaction of legal and regulatory requirements of the Building Societies Commission, the Bank of England and the London Stock Exchange, the preparation of the Transfer Document and of the Listing Particulars. "Due diligence" work including the verification of corporate and subsidiary companies structure was carried out and the Memorandum and Articles of Association were prepared.

(iii) Register : This involved the production of a validated register of members for the purposes of the voting process and for share and cash bonus distributions. Much of the work was involved in "de-duplicating" membership records.

(iv) Logistics : This involved mailing and all customer contact, provision of programme support, timetable management and accounting and budgetary control,

preparation and implementation of the special general meeting at which the vote was taken.

(v) Communications : Effective communication was required between the Halifax and its members, customers, employees/pensioners, the media, institution investors and analysts, overseas markets, regulators and politicians by means of mailings, press releases and the telephone "helpline".

(vi) Treasury : Work was carried out to achieve Bank of England approval involving the satisfaction of Bank of England reporting requirements, due diligence work, provision of investor relation services and a new listings for security.

Of the total expenditure of £184.8 million, the following are the principal ingredients:

Staff and staff-related costs £20.2 million

Literature/stationery/printing £20.1 million

Postage and mailing £22.8 million

Communications and advertising £25.5 million

Legal and advisory £33.4 million

Share registration/distribution £30.8 million

Statutory cash bonuses £14.9 million

Events leading to the decision to convert

13. The Halifax was founded in 1853 as the Halifax Permanent Building Society (The earliest form of building societies were "terminating" societies which were formed by persons wishing to join together to finance the construction of houses. Each member paid a sum to the society to finance building work until a house was built for each member; at this point the society was wound up. Over time such limited life societies were replaced by permanent organizations designed to raise funds from depositing members to finance loans made to borrowing members for the purpose of house purchases and secured on the property so purchased.) The Halifax grew in size and spread its activities throughout the United Kingdom, merging from time to time with other societies, the most significant being the merger with the Halifax Equitable Building Society. By 1988 a quarter of all building society mortgages in the United Kingdom were with the Halifax. In February 1989 the Halifax issued a mission statement "to become a leading retail financial services group, retaining our lead in the supply of UK housing finance, and providing

a range of financial products and services profitably and well, so as to meet customer needs".

14. Until conversion on 2 June 1997, the Halifax was a "mutual" organization owned by its members. The members were the depositors, who held ordinary share accounts ("investing members"), and borrowers, who held mortgage accounts ("borrowing members") with the Halifax. As such an organization the Halifax was run in accordance with the "mutual" principle, so that the directors were, according to the statement made in the Transfer Document, (para 2.3.1) required by law to act in the best interests of the membership as a whole. The investing members had voting rights, rights to requisition meetings to nominate directors and to receive financial information about the building society. They had the collective right to receive the whole of any surplus on the dissolution of the society so long as they had, throughout a period of two years before the commencement of the dissolution, shares of a value of not less than £100. The borrowing members had voting rights on "borrowing members' resolutions" and the right to receive financial statements and accounts of the building society.

15. Traditionally building societies simply raised funds from their investing members which were then lent to borrowing members to purchase their homes so that the majority of customers of building societies were members. However, in more recent times building societies started to offer their customers products and services which did not confer membership of this society, e.g. current accounts and non-secured personal loans. As a result of this development, the interests of the members of the Halifax ceased to be synonymous with the interests of the Halifax's customers, a feature which is relevant in determining the reasons for the conversion.

16. Prior to conversion the Halifax was the largest mortgage lender in the United Kingdom. In the 12 months to 31 January 1996 the Halifax had 17.6 million savings and investment accounts (approximately an 18% share of total United Kingdom net liquid savings - i.e. savings with banks, building societies and other financial institutions), just under 2.5 million residential mortgages with total mortgage balances of £75,558 million (the largest share of United Kingdom net mortgage lending at approximately 20%), 1,083 branches and 11,079 agencies (i.e. independent persons, often estate agents or other insurance brokers who offered the Halifax's products to customers). At the end of 1996 the Halifax had 1.3 million current account holders, it provided 24 hour telephone banking and took 7% of the "new-banking" market. In 1995-96 the Halifax made profit before tax of £933 million (to - £552 million after tax) on total assets of £98,387 million and general reserves of £6,236 million.

The business of the Halifax Building Society and of relevant subsidiaries

17. Operating under its reformulated mission statement "Our goal is to become the UK's leading provider of personal financial services", the Halifax and its subsidiaries were organized into six different business sectors i.e. mortgages, liquid savings, retail banking and consumer credit, treasury, personal lines insurance and long-term savings and protection products.

18. The activities of the Halifax Building Society itself were as follows -

(1) The "mortgages" business offered fixed and variable rate mortgage products, including those repayable by pensions, PEPs and endowments. Its business was primarily in respect of residential purchasers to whom both mortgages and remortgages were offered.

(2) The "liquid savings" business offered the "Gold" range of savings products, including instant access and notice accounts, TESSAs and fixed rate products. It also administered savings schemes for approximately 1.1 million employees of 500 UK companies. Access to savings was offered via the Halifax branch network, its own cash machines or via reciprocal arrangements with other financial institutions.

(3) The "retail banking and consumer credit" business included the Halifax current account, debit cards and personal loans. It offered "Halifax Direct" 24 hour telephone banking.

(4) The "treasury" business provided group funding and liquidity. The Halifax's treasury operations encompassed managing liquidity, raising wholesale funds and controlling interest rates and currency risks. The treasury also carried on a commercial lending business primarily to housing associations.

(5) The "personal lines insurance" business offered buildings, contents and motor insurance, arranged by the Halifax but underwritten by third party insurers.

19. Certain activities of the group were carried on by subsidiaries. Those included -

(1) Halifax Loans Ltd ("HLL") and its subsidiary Halifax Mortgage Services Ltd ("HMSL"). HLL had been set up to purchase "staff loan books" from other financial institutions. The purchase of such loans fell outside the primary purpose of building societies under the 1986 Act (which was to make loans secured on residential property rather than to purchase or otherwise take transfers of such loans). HLL's net assets were, at 31 December 1996, 1.18% of group net

assets and it contributed 2.59% to group pre-tax profits.

(2) HMSL was originally a mortgage vehicle of Banque Nationale Paris. It was purchased as a separate company with an existing book of mortgage loans. The business was kept in the separate company partly because the acquisition fell outside the Halifax Building Society's primary statutory purpose and partly because mortgagors on an "acquired book" would not rank as borrowing members of the society. At 31 December 1996 HMSL's net assets were zero (there was a deficit of £13.9 million) and it contributed 1.28% to group pre-tax profits.

(3) Offshore licence deposit taking was carried on by two subsidiaries, Halifax International (Jersey) Ltd and Halifax International (Isle of Man) Ltd. These existed primarily in order to attract the deposits from expatriates at a time when deposit-takers within the United Kingdom had difficulty in paying interest gross to non-residents. These businesses were constituted as separate subsidiaries authorized as banks in Jersey and the Isle of Man respectively. At 31 December 1996 their net assets were 7.41 and 4.76 per cent respectively of group net assets and they contributed losses of £9.2 million and £6 million respectively to group profits.

(4) Mortgage indemnity business was provided by Halifax Mortgage Re Ltd in Guernsey and negative equity insurance by Halifax Guarantee Insurance Ltd. Section 16 of the Insurance Companies Act 1982 required insurance underwriting to be carried out by a separate corporate entity; the same applied under equivalent regulatory provisions throughout the European Union. At 31 December 1996 those companies' net assets represented 0.56 and 0.12 per cent respectively of group net assets and they contributed 0.2.8 and 0.03 per cent to group pre-tax profits.

(5) The Halifax Building Society and the Leeds (with which the Halifax merged prior to conversion) had, in the early 1990s, started life insurance operations. The purpose of setting up their own operations had been to acquire the "proprietor's share" of the "embedded value" of endowments at a time when endowment mortgages were popular; "the embedded value of an endowment" is the value of premiums to be paid during the future life of the policy. This insurance business had to be carried on by a subsidiary because it was separately regulated by the Insurance Companies Act 1982. These policies were sold through Halifax branches by personal financial advisers. The Financial Services Act 1986 required the personal financial advisers to be appropriately qualified and regulated and they were not therefore regular branch staff. However a commission was paid by the Halifax Life Ltd to the Halifax Building Society in return for the introduction of the business. Shortly before conversion the Halifax

purchased the business of the Clerical and Medical Insurance Group Ltd. Halifax Life's net assets at 31 December 1996 represented 5.61% of group net assets and it contributed 1.79 per cent to group pre-tax profits.

(6) The banking business in Spain was conducted by Banco Halifax Espana SA: a separate local company was required for regulatory reasons. Its contribution to group pre-tax profit for the period to 31 December 1996 was 0.57%.

(7) Halifax Financial Services (Holdings) Ltd conducted the financial advisory service; a separate company was required for regulatory reasons by the Personal Investment Authority. At 31 December 1996 it had a small negative net asset value and its contribution to group net profits was a loss of some £6 million.

(8) The estate agency business was carried on by Halifax Estate Agencies Ltd. This had to be a separate company regulated by the Department of Trade and Industry. In the period to 31 December 1996 it contributed a loss of £9.2 million to group pre-tax profits.

(9) The credit card business carried on by Halifax Credit Cards Ltd was at first joint venture with the Bank of Scotland and thus had to be a separate company. In the period to 31 December 1996 it contributed 2.59 per cent to group pre-tax profits.

(10) Halifax Syndicated Loans Ltd (HSL) carried on business making syndicated loans, primarily to housing associations. The Building Societies Act 1986 did not allow societies to make syndicated loans, hence the need to use a separate subsidiary. In the period to 31 December 1996 it contributed 0.39% to group pre-tax profits.

20. In the 12 month period to 31 December 1996 the turnover of Halifax Building Society was £2,106.9 million, representing 74% of group turnover. Its profit of £811.1 million represented 93.24% of group profit and the net assets attributable to the building society business were 77.71% of the total.

Regulatory position under Building Societies Act 1986

21. The Building Societies Commission was created in 1986 pursuant to the BSA. Section 5 of BSA restates the traditional purpose of building societies as being their "principal purpose", being "that of raising, primarily by the subscriptions of the members, a stock or fund for making to [members] advances secured on land for their residential use." Loans made pursuant to this primary purpose were, broadly speaking, classified as Class I commercial assets. Mortgage loans where there was a prior charge, or where the property was not owner occupied, were classified as Class II commercial assets. Everything

else, including overdrafts, credit card loans, investments in subsidiaries etc, ranked as Class III commercial assets: section 20.

22. The 1986 BSA and the subordinate legislation made under it were, to use Mr Terence Mathew's expression, "firmly prescriptive in nature". Building societies were able to do only those things laid down in the Act and subsequent statutory instruments. In particular, they were subject to four so-called "nature limits" imposed by the Act and operated by the Commission. These were -

(1) The "wholesale funding" rule limited societies to an absolute maximum of 40% non-retail funding (i.e. funds other than customers' deposits) which they were permitted to raise; section 7 of BSA. The actual amounts permitted by the Commission were lower. The Commission used its "prudential powers" to review a society's funding policy as soon as the society proposed an increase in its maximum wholesale funding of more than 5% above the then permitted limit, and at various steps of the Commission's choosing thereafter.

(2) The "membership funding" rule limited societies to an absolute maximum of 50% non-membership funding (i.e. funds other than those customer deposits which qualified as share accounts conferring memberships) which they were permitted to raise (section 8).

(3) The "commercial assets structure" rule dictated the composition of the society's assets (other than fixed assets liquid asset), and this required that at least 75% of such assets had to comprise mortgage loans to owner/occupiers of residential property (Class I assets) and no more than 15% might comprise assets other than loans secured on property.

(4) The "liquidity" rule prohibited societies from holding more than one third of their total assets as liquid assets and enabled the Commission to prescribe which liquid assets a society might hold (section 21).

The BSA and its implementation by the Commission restricted the types and range of activities that the building society could carry on, the manner in which they could do it, the speed with which they could react to commercial pressures and operations, and the policies by which they regulated their own businesses and the manner in which they raised funds. During the 1980s and 1990s leading up to the time of conversion the dividing lines between banks, building societies and insurance companies became less distinct. Building society customers were increasingly seeking alternatives to deposit-based savings, such as equity-linked investments; equally, societies were offering a much wider product range. This broader range of lending and borrowing products were also being distributed in

different ways, especially through telephone based services. As the building societies diversified their activities the constraints imposed by the BSA were, we were told, felt more acutely.

The growth of competition

23. In the early 1980s building societies had been largely conservative and uncompetitive. They raised funds from deposits of members and lent on security of residential mortgages. They were prevented from offering financial services unconnected with those objectives; but the "composite rate tax system" gave them a limited advantage over banks as regards interest-bearing deposits. Until the "supplementary special deposit scheme" (the "corset") was lifted at the start of the 1980s banks also had their ability to lend (and therefore to accept interest-bearing deposits) restricted. Until the early 1980s the building societies were exempt from restrictive trade practice regulations and were free to enter into their own interest rate fixing arrangements.

24. From the early 1980s onward the restrictions and boundaries between the building societies, banks and life assurance companies became less distinct. The appearance of mortgage brokers increased public knowledge and the growth of retail financial journalism heightened public interest in the practices and products of the financial services industry. As time went by a significant number of building societies and banks added life assurance, pension and unit trust products to their activities; at the same time, a number of major insurance companies started to offer banking services. Building societies increasingly sought alternatives to deposit based savings, such as equity linked investment. In addition to residential mortgage lending, building societies have added a wide range of financial products and services to their activities. These includes savings accounts, current accounts, credit and debit cards, life assurance, pensions, unit trusts and PEPs, general insurance products covering buildings, contents and motor insurance, health insurance plans and travellers' cheques. This broader range of products was distributed in different ways, especially through telephone-based services; for example, the Halifax Direct call centre was established in September 1995.

25. The diversification of activities by the Halifax and other building societies imposed competitive pressures upon them to obtain the benefits of economies of scale and to reduce costs. They could no longer, Mr Foulds explained, protect the margin between interest received by them and interest paid by them; consequently they needed to broaden their access to cheaper forms of "wholesale" funding. Throughout the United Kingdom personal financial services industry institutions were consolidating and merging their activities so as to obtain the benefits of

economies of scale and to reduce costs. However the tight constraints imposed by the BSA and the Building Societies Commission limited the freedom of building societies such as the Halifax to adapt to meet these competitive pressures.

Events leading to conversion

26. The first full consideration to the issue of conversion was given by the Board of the Halifax Building Society in 1988. The then directors held a series of meetings to discuss the advantages and disadvantages of conversion in the light of the then regulatory and competition position. In July 1988 a decision was taken not to pursue conversion "at that time" although, Mr Foulds told us, the issue "might well have to be reviewed in four to five years time". Mr Foulds explained that, at that time, the constraints on access to capital were not such as to make conversion necessary. But the executive directors, in his view, would have been in favour of conversion because the society had by then outgrown the simple building society in size and range of activities. Conversion, he explained, remained very much on the agenda and was discussed by members of the board on a number of occasions in the early 1990s. The recession in the housing market at the start of the 1990s and the consequent provisions being made by building societies put a standstill on conversion and flotation considerations. But by early 1994 the housing market had picked up and the financial position of societies had improved. Mr Foulds expressed the view that the Halifax Building Society was then in danger of becoming too small to compete effectively in the UK let alone on a Europe-wide basis. His view was that they had to expand to stay competitive.

27. A Strategic Review Conference took place in February 1994. Later in 1994 there were further discussions of the issue of conversion. These took place at directors' meetings, the minutes of which set out fully the considerations taken into account. Meetings were held during the summer and early autumn of 1994 in which the issue of a merger with the Leeds and subsequent conversion of the merged entity were discussed. At these meetings representatives of both building societies were present and the minutes record the discussions. A meeting of the directors took place on 19 October 1994 at which representatives of Linklaters & Paines (lawyers) and S G Warburg (bankers) were present. A full discussion of all the implications of merger and conversion took place. The resolution of the board is recorded as follows:

"Whilst the policy of the Society was to remain a mutual under current circumstances, if the merger were implemented, the Directors intended to put a proposal to the members of the Society, at an appropriate time, that the business and engagements of the Society should be

transferred to a specially formed company, subject, inter alia, to the determination of a satisfactory proposal within the terms of the Building Societies Act 1986, BSC confirmation of the draft transfer statement, Bank of England approval of the successor company as a bank and satisfactory market conditions."

On 25 November 1994 the Halifax Building Society announced that it was proceeding with a merger with the Leeds and with conversion of the new merged entity. We shall return to the reasons behind the decision to convert and consequently to incur the disputed expenditure. In the meantime we summarize the steps that had to be taken as part of the conversion process.

Required steps in conversion process

28. The conversion process required satisfactory completion of three separate stages. These were Building Societies Commission approval, Bank of England authorisation and Stock Exchange listing. The requirements of those three bodies resulted in the incurring of the disputed expenditure.

29. The procedure for conversion from building society to a commercial company are prescribed by the BSA. This requires the approval of its members by the passing of transfer resolutions that need a high turnout and majority of votes. The form of these depends on the procedure adopted for conversion. The BSA refers to the successor entity as "the existing company [successor]" and "the specially formed company [successor]" as the case may be. The existing company route presupposes a takeover by an outside institution with loss of independent status to the target building society; consequently the level of support for members needs to be higher than the specially formed company route which presupposes that the building society retains its independent status albeit in a new corporate form. The specially formed company route provides for a protected period during which the new entity cannot be taken over, save in exceptional circumstances; however, until the 1996 BSA came into effect, it involved the company setting up a substantial reserve, the "priority liquidation distribution reserve" to protect the interest of depositors who ceased to be members. The Halifax's choice of the existing company route involved the use of a "captive" subsidiary and so did not involve any loss of independence. It adopted this route to avoid having to create the reserve but at the price of having to obtain the much higher voting levels from its members and of foregoing the period of protection. (The need to create the reserve had been abolished by the time of the conversion of the Halifax Building Society into Halifax plc; this was not foreseen when the existing company route was chosen.)

30. The voting levels required for conversion by the

specially formed company route were (i) a simple majority of borrowing members with no minimum turnout and (ii) a 75% majority of saving members with a minimum turnout of 20% of those qualified to vote. For the existing company route the borrowing members' resolution is on the same terms as that required by the specially formed company route. But the saving members' resolution requires a vote of not only a special majority of 75% of those voting on the poll but also requires that those voting in favour must constitute not less than 50% of the members qualified to vote (by number) or 90% (by value of shares held).

31. The implications of these voting requirements (especially to the Halifax, because of its decision to adopt the existing company route) were stressed by Mr Foulds and by Mr Christopher Knight. The Halifax, for example, had 17.6 million savings and investment accounts in 1966. To achieve conversion, it was necessary to communicate with all those members and to provide them with information about the process. Above all it was essential to satisfy the two voting conditions. The members had to be encouraged to vote and to be given the opportunity of realizing their shares in the successor plc as part of that process. The society could not afford to get it wrong; to do so would jeopardize both the prospects of conversion and the long term loyalties of the members who became customers after conversion.

32. While the Building Societies Commission is neutral on the question whether a society should or should not choose to convert, it has a range of statutory obligations to such societies derived from its ordinary task of "prudential supervision". In 1996 the Building Societies Commission published guidance notes on conversion and take over procedures. The following items are relevant to the present proceedings -

- A board's decision to convert must be based, and be seen to have been based, upon a strategic assessment of how the society can best serve its members. This requires a forward plan. The assessment and the forward plan form the basis for the "Transfer Document" and the submission to the Bank of England for authorization.

- The Building Societies Commission is to be consulted at an early stage and will appoint a project team of its own and will expect the converting society to appoint a project team to control the drafting of the Transfer Document and to take responsibility for all communications with members.

- Each member is entitled to receive the Transfer Document including a notice of the meeting at which the relevant transfer resolutions are to be moved. The Transfer Document must be approved by the

Building Societies Commission in relation to all required particulars such as details of the share distribution scheme, the consequences of conversion for members and employees, the financial history and position of the society, the intended activities of the successor, a full disclosure of transactions within the previous twelve months and a summary of the costs and expenses of the transaction.

- Every society is required to maintain and register the names and addresses of its members, irrespective of whether it proposes to undertake a conversion. Many large societies had allowed their registers of members to include considerable "duplication". This had arisen through the proliferation of different types of savings product developed in the 1980s; these resulted in a single person having a number of different savings accounts with the society at the same time.

The "duplication" problem called for a great deal of "de-duplication" work within the society. The Building Societies Commission requires Bank of England confirmation that the latter expects to authorize the successor company to carry on banking business before approving the Transfer Document; this calls for a close involvement with the Bank at an early stage in the conversion procedure where, as here, the converting companies require full banking status.

33. The Bank of England required a number of steps to be taken, such as the presentation of an acceptable "business plan", for the purposes of securing authorization under the Banking Act 1987.

34. The London Stock Exchange required "listing particulars". It was an essential part of the listing process that the shares be introduced to the market without undue volatility or turbulence; the converting society had to take steps to ensure the smooth migration of the shares from members wishing to sell to institutions wishing to purchase. This, Mr Knight and Mr Foulds explained, was a reason for the incurring of expenditure on the share dealing service and the "single company PEP".

Appointment of Advisers

35. The Halifax appointed the following professional advisers to advise on the planning and implementation (particularly the necessary regulatory steps) of the conversion project -

- A public relations company was engaged to provide consultancy services comprising comment on press coverage, on press releases and information to members, assistance and handling the media and support for the development of a plan for marketing

and investor relations programmes prior to flotation.

- SBC Warburgs were engaged to, among other things, provide advice to the Board on the terms of timing and conversion, to assist in negotiations with the regulators, to advise on the flotation process , to assist in the preparation of the Transfer Document, to instruct KPMG in the preparation of an accountants' report, to advise on the capital structure, to advise on the marketing to potential shareholders and to advise on compliance with the listing rules of the London Stock Exchange. SBC Warburg cease to act for the Halifax in March 1996. Deutsche & Morgan Grenfell were then engaged on similar terms.

- Linklaters & Paines were engaged to provide all necessary legal advice on the conversion process.

- KPMG were engaged to provide general financial and accounting advice on conversion, to provide the relevant accounts and reports, to report on the financial information included in the Transfer Document and the application to the London Stock Exchange, to advise the directors on the current trading of the Halifax and to provide various letters, memoranda and comfort letters.

- Stockbrokers (Merrill Lynch) were engaged to advise on the terms and timing of conversion, to assist in the preparation of the Transfer Document and to assist in the marketing of the Halifax to potential shareholders and to deal with arrangements on flotation and to advise in relation to listing rules.

- Cazenove (broking) were engaged to advise the Halifax on stock marketing aspects of flotation.

- Allen & Overy (legal) advised on the establishment of the "Treasury Bank" subsidiary: this did not in fact come into being.

Internal organization framework

36. The Halifax set up a board conversion sub-committee chaired by the chairman of the board. Programme directors were appointed and the conversion programme was placed under the control of Mr David Walkden whose evidence was contained in a Witness Statement. The conversion procedures were divided into six "Charters" (finance, legal and regulatory, register, logistics, communications and treasury) each of which had a number of different tasks. By the end of the project some 29,000 employees had received special training (and to the extent that their salaries related to work done on the conversion programme, these are the subject matter of the present

dispute), 20 million customer records had been checked for accuracy and duplication, 50 million items of post had been printed and mailed to customers, 6 million telephone calls had been received, 300,000 customer letters had been received and responded to, 150,000 parcels or re-branded stock had been distributed to 2,500 high street sites and the largest single shareholder register in the United Kingdom had been created in a £18 billion company.

The formal steps in the conversion

37. The conversion was achieved under the BSA 1986 section 97. Five main steps were involved -

(i) Halifax Building Society subscribed £573.9 million of cash (representing reserves that were members' funds) for shares in an existing subsidiary which was renamed Halifax plc: Halifax plc was to "assume the conduct of the Society's business in its place".

(ii) Halifax Building Society entered into a Transfer Agreement of 20 December 1996 with Halifax plc under section 97 conditional on member and regulatory approvals. On 24 February 1997 the members approved the transfer (and conversion) at a special general meeting.

(iii) On the vesting day (1 June 1997) Halifax Building Society transferred its business to Halifax plc.

(iv) Halifax Building Society distributed its shares in Halifax plc to its members and out of its reserves paid the statutory cash bonuses as required by section 100 of BSA to members who were not eligible to vote on the transfer resolution and

(v) the building society was dissolved.

Under the terms of the Transfer Agreement the business of the building society was transferred and vested in Halifax plc "as if, in all respects, the [society] and [Halifax plc] were the same person in law".

The "Treasury Bank" proposal

38. If the Halifax Building Society had decided to transfer its business to a specially formed commercial company then for regulatory reasons it would have had to create a separate treasury bank. However, because the Halifax Building Society chose to transfer its business to an existing subsidiary, a separate treasury bank was not

required and was not formed.

Halifax Share Dealing

39. "Halifax Share Dealing" is a growing business within the group. Initially it was provided for dealings in Halifax shares only on conversion day when it processed the sale of more than 568m shares as well as customers' purchases. During the rest of 1997 the operation regularly handled up to 75% of the total number of retail trades in Halifax shares on the London Stock Exchange with 120 staff. Halifax Share Dealing is a member of the London Stock Exchange and is regulated by the Securities and Futures Authority. The 1997 Annual Report indicated that there were important development plans for 1998, which included launching a dealing service for all UK equities.

Halifax Single Company PEP

40. In 1997 the Halifax Single Company PEP was successfully launched to cater for shareholders wishing to retain their shares in a PEP. At the end of December 1997 it had 278,000 holders with funds totalling some £1.1bn, making it the largest single company PEP in the United Kingdom.

Post conversion events

41. As a result of instructions given prior to the vesting day, some 1.9 million new shareholders sold their shares at the weighted average price of 732.5p per share.

42. On 19 June 1997, in accordance with section 100(2)(b) of the BSA, the Halifax paid statutory cash bonuses of £14.9 million. Not all members of Halifax Building Society were entitled to an issue of shares in Halifax Plc. Section 100(2)(b) directed that statutory cash bonuses be paid to members who were holders of share accounts on 31 December 1996 and who were not entitled to vote (because they were under 18 or because their share account balance was lower than £100). The deductibility of these payments is challenged and we will refer to the details of them later.

43 A small number of members who did not receive their full entitlement to shares were provided with compensation.

44. On 2 June 1997 the Bank of England formally authorized the Halifax plc under the Banking Act 1987. With effect from conversion the Halifax became regulated by the Bank of England as a subject to the Bank's capital adequacy, liquidity and reporting requirements, a member of the banking Ombudsman Scheme and signatory to the Code of Banking Practice.

The wholly and exclusively issue

45. This issue turns on the application of section 74(1)(a) of the Taxes Act which directs as follows -

"(1) Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of -

(a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation;"

The judgment of Millett LJ (as he then was) in Vodafone Cellular Ltd v Shaw [1997] STC 734 at 742 sets out the propositions of law which the findings of fact must satisfy if expenditure is to be allowed. He referred to Mallalieu v Drummond [1983] STC 665 and MacKinlay v Arthur Young McClelland & Co [1989] STC 898, [1990] 2 AC 239, and derived from those decisions of the House of Lords the following propositions:

"(1) The words for the purposes of the trade means to serve the purposes of the trade. They do not mean for the purposes of the taxpayer but for the purposes of the trade, which is a different concept. A fortiori they do not mean for the benefit of the taxpayer. (2) To ascertain whether the payment was made for the purposes of the taxpayer's trade it is necessary to discover his object in making the payment. Save in obvious cases which speak for themselves, this involves an enquiry into the taxpayer's subjective intentions at the time of the payment. (3) The object of the taxpayer in making the payment must be distinguished from the effect of the payment. A payment may be made exclusively for the purposes of the trade even though it also secures a private benefit. This will be the case if the securing of the private benefit was not the object of the payment but merely a consequential and incidental effect of the payment. (4) Although the taxpayer's subjective intentions are determinative, these are not limited to the conscious motives which were in his mind at the time of the payment. Some consequences are so inevitably and inextricably involved in the payment that unless merely incidental they must be taken to be a purpose for which the payment was made.

To these propositions I would add one more. The question does not involve an enquiry of the taxpayer whether he consciously intended to obtain a trade or personal advantage by the payment. The primary enquiry is to ascertain what was the particular object of the taxpayer in making the payment."

The fourth proposition expresses what is colloquially known as "the Mallalieu purpose" and is drawn from the House of

Lords' decision in Mallalieu v Drummond.

46. The Inland Revenue's case for disallowance of the expenditure is that the object of the Halifax, through its board in incurring the expenditure, had been to benefit both the core trade (carried on until conversion by Halifax Building Society) and activities that were not part of its trade. It was argued that the particular objects which the Directors had sought to achieve were the following:

(1) As regards the elimination of the constraints of the BSA regime, the purpose of the expenditure was to benefit not just the trade of the building society but also the trades of certain subsidiaries and the building society's holding company operation. Reliance was placed on Harman J's decision in Commercial Union Assurance v Shaw [1998] STC 386 where he upheld the disallowance of certain expenditure on the grounds that this money was being used for the benefit of the trading subsidiaries of the appellant as well as for the benefit of the trading subsidiaries of the Commercial Union's trade (page 402).

(2) The object of securing access to new sources of funding was not to be characterized as for the benefit of the core trade alone. It was also for the benefit of the trades of certain of the other lending subsidiaries.

(3) The particular object of resolving the tension between the interests of members who were customers on the one hand and customers who were not members on the other was not properly to be characterized as a trade purpose.

(4) To the extent that the object was to make members' equity share owners in the new entity, the purpose was not to benefit the trade but to benefit the owners of the trade.

(5) An object was to release value to the members of the Halifax. This was not a trade purpose.

(6) An object was to secure the merger with the Leeds: this was not a trade purpose as being designed to benefit the proprietors of the trade.

Moreover, it was argued, all the effects identified in grounds (1) to (6) were consequences so inevitably and inextricably involved in the expenditure that they should be taken to be Mallalieu purposes even if not "consciously" regarded as such; and none of them was merely an incidental effect of the expenditure.

47. The case for the Halifax is that the purpose of the conversion and consequently of the expenditure was to benefit the trade of the Halifax, i.e. the building society business, and not to benefit the trades of any other companies in the group. That was the only proper

conclusion to be drawn from the evidence.

48. To ascertain the real purpose for which the expenditure was incurred we have to discover the object of the Halifax in incurring the expenditure; this involves an enquiry into the Halifax's intentions at the time of incurring the expenditure. For this we have examined the intentions of the board of the Halifax. We have used the Transfer Document, which was drawn up under the supervision of the Building Societies Commission, as one prime source of evidence. The reasons for conversion set out in it are substantially the same as those found in other formal documents. By the time the reasons were fully formulated the board contained representatives of both the Halifax Building Society and of the recently merged Leeds. However, at the time the decision to convert was taken (at the 19 October 1994 Meeting), there were no Leeds directors on the board. We have, therefore, drawn on board minutes and papers leading up to the decision to recommend conversion. We have also placed considerable reliance on the oral evidence of Mr Foulds. We are satisfied from an examination of the board minutes and papers and from his own evidence that Mr Foulds was in a position to speak for the board of the Halifax Building Society. He was chairman at all material times. He was taking a lead in the deliberations. The minutes record a unanimity of approach. Different directors may have had different priorities, but as regards the key reasons for conversion, they appear to us to have been at one.

49. Our starting point is the statement of "Reasons for Conversion" contained in the Transfer Document. Section 1 of Part A of this summarizes the recent events and developments in the personal financial services industry; it then reviews the strategic options open to the Halifax. These it lists as either remaining a building society and growing organically, or merging with one or more building societies or converting to a public company. The main factors taken into account by the Board in reaching their conclusions are then identified. We will return to these. Section 1 concludes with the "Recommendation" as follows -

"The Board believes that conversion is in the best interests of Halifax's members, other customers and employees. Accordingly, the Board unanimously recommends that Halifax should become a public company by transferring its business to Halifax plc and strongly recommends members to vote "For" the appropriate resolution(s) to be proposed at the Meeting."

50. The Transfer Document's summary of recent developments highlights two features of the changing environment in the UK personal financial services industry. The first is the growth in the housing market in the 70s and 80s followed by the decline during the recession of the

early 90s and by the increase in competition to grant mortgages. The second feature is the breakdown of barriers between the businesses of the banks, building societies and life assurance companies and the consequent demand by building society customers for other financial services which building societies have started to provide.

51. The Transfer Document states the "Strategic Objectives" of the Halifax as follows -

"Halifax has been at the forefront of developments in the personal financial services industry in the UK. Its strategy has been to develop a range of complementary core businesses to establish itself as the UK's leading provider of personal financial services.

Notwithstanding its size and capacity to develop new products and establish distribution channels, the Board believes that the Society's ability to remain at the forefront of the personal financial services industry in the UK could be constrained unless it has the same flexibility to operate and to fund its business as its non-building society competitors."

It goes on to state that, in assessing the options, it has taken six main factors into account i.e (i) flexibility, (ii) regulatory regime, (iii) "owner/customer relationship", (iv) access to capital, (v) Treasury activities and (vi) release of Halifax's value. We shall summarize each of these more fully when dealing with the particular Inland Revenue arguments. Factors (i), (ii), (iv) and (v) are directly relevant to the first two of the Inland Revenue's contentions to which we now turn.

52. Was it, as the Inland Revenue contend, the Halifax's purpose in incurring the expenditure to benefit not just its own trade but also the trades of subsidiaries or its (non-trading) holding company operations or both? The incurring of the expenditure started shortly after and as a consequence of the Halifax Board's decision to convert taken in October 1994. We therefore examine the evidence to determine what was the board's purpose; in doing so we look for the self-evident but not necessarily conscious Mallalieu purposes, if any.

The subsidiaries and the holding company operation

53. The first "non-trade" purpose alleged by the Inland Revenue was that expenditure incurred with the object of removing the constraints of the BSA was incurred for the purposes of the subsidiaries' trades and the Halifax Building Society's non-trade holding company operation. To the extent that the expenditure was incurred to give access to wholesale sources of funding this purpose (it was alleged) was directed at the trades of the subsidiaries as well as at

the trade of the Building Society.

54. Commercial Union Assurance Co v Shaw (1998) relied up by the Inland Revenue was concerned with the deductibility of charges on income relating to borrowings of Commercial Union which were used to finance the trading needs of the Commercial Union and of various UK and overseas subsidiaries. The Court upheld the general commissioner's decision that, in the light of the finding that the purposes of the borrowing had been to assist the subsidiaries, the charges were not expenditure of Commercial Union laid out of the purpose of its trade. There, as Harman J observed on page 402c, the money had actually been used to benefit the trading activities of the subsidiaries. The facts of that case show that Commercial Union had raised the finance itself and paid all the costs and then provided funding free of charge to its subsidiaries (pp 391F and 402B). Here no part of the conversion expenditure has discharged any liability of any of the Halifax's subsidiaries, which were required to pay interest to the Halifax at a rate that gave the Halifax a margin of profit. The decision gives little help to our task which is whether we can infer from the evidence as a whole that the conversion expenditure was laid out for the purposes of the subsidiaries' businesses.

55. Returning to the four "factors" (referred to in The Transfer Document as taken into account by the board, see paragraph 49 above) relevant to this issue, the first is "flexibility". There must, it is said, be greater flexibility than is currently available to a building society if the Halifax is "to pursue new opportunities and take advantage of changes in the financial services industry". The second factor, headed "regulatory regimes", is based on the BSA constraints and concludes that "the Society will benefit from a regulatory regime which will not require it to have its principal purpose as making loans which are secured on residential property". It was urged on us for the Inland Revenue that the pursuit of "new opportunities" was as applicable to subsidiaries as it was to the Halifax's core business; the conversion expenditure must therefore have been incurred for the purpose of benefiting the subsidiaries.

56. Factor (iv) is headed "access to capital". The first form of capital referred to is "equity capital". With shares listed on the Stock Exchange, the Document says, Halifax will have "the ability to raise capital and support new initiatives, including acquisitions, by the issue of new shares". There is no suggestion in the Transfer Document, or in any other evidence that we saw, that the board of the Halifax had any intention of doing this and no new shares have, in fact, been issued. Mr Foulds was questioned about this and said of this factor that it was one of the "ancillary benefits from an operation which was conceived for a whole variety of different reasons". (5/102) The second form of capital referred to in factor (iv) is "debt capital". Following

conversion, the Document pointed out, a wider range of markets would be accessible and "the group's" ability to fund business opportunities would be improved. (There was, we observe, no mention in the Document and no evidence of any "group" plans to embark on new business opportunities.)

57. Factor (v) refers to "Treasury activities". The BSA regime, it is said, "creates obstacles to obtaining wholesale funds from overseas investors"; it restricts the "range of risk management instruments" (e.g. for hedging). Conversion would remove those difficulties and maintain "Halifax" competitiveness".

58. Those four factors are related in the sense that they all have to do with the constraints imposed by the BSA regime and with the advantages of converting to a plc. We turn now to examine the record of the board discussions to see if they have any bearing on the question of whether the purpose or one of the purposes of the conversion expenditure was to benefit subsidiaries or the holding company operations.

59. The "strategic review" conference of the board of Halifax in February 1994 marked the start of the decision-making process leading to the decision to merge with the Leeds and to convert to a plc. At that conference restrictions on wholesale funding had been identified as a problem. Retail deposits were expected to grow more slowly than Halifax's demand for funding; a 36% wholesale funding level might be needed by the year 2000. (Mr Foulds explained in evidence that the tight constraints imposed by the Building Societies Commission would make it difficult to achieve that level. The 40% statutory limit was subject to a lower negotiated "nature" limit and an even lower "trigger" limit - i.e. the point at which the Building Societies Commission had to be notified; this meant that under the BSA regime the Halifax had to operate at well below the statutory limit.) The need to develop a "treasury operation" to manage wholesale funding and group liquidity was further identified. Mr Foulds mentioned that the Bank of England had turned down the Halifax's application to set up a separate bank.

60. The strategic review concentrated on the Halifax's core building society business and its development. Conversion, if it is to be adopted, is seen as relevant only the needs of that core business. Then came discussions with the Leeds board about merger with or without conversion. These are dealt with more fully later. At this stage we observe that no consideration was given to the trading operations of the subsidiaries of either society. Indeed none of the activities of the subsidiaries is referred to. Nor did they surface as topics for discussion or even considerations at the final meeting on 19 October 1994 when the board decided to

recommend merger and conversion.

61. Turning to the oral evidence we mention briefly the unchallenged evidence of Mr Terence Matthews (set out in paragraphs 21 and 22 above) to the effect that the BSA regime was prescriptive and restrictive of the type and range of activities that a building society could carry on. The Halifax was therefore restricted as to the type of business it could carry on, the speed at which it could react to commercial pressures and opportunities, the policies by which it arranged its business and the manner in which it raised funds.

62. Mr Foulds' evidence was that the Halifax had considered conversion for essentially four reasons. First, there had been concern about its medium and long term ability to raise sufficient debt capital to allow it to expand its mortgage business and its treasury operations; secondly, access to the wholesale money market was severely restricted for building societies; thirdly, there were difficulties in reconciling the interests of customers who were members with those who were not and the different interests of different categories of members and fourthly the regulatory regime laid down by and under the BSA hampered its ability to carry on its core mortgage lending and personal savings business. In deciding to convert Mr Foulds confirmed that the Halifax had taken into account each of the six factors referred to in the Transfer Document. Conversion, he said, had been undertaken solely for the purpose of benefiting the financial services trade carried on by the Halifax, then as a building society and now as a bank, by removing restrictions on the efficient operation of that business. It had not, he said, been the purpose of conversion to benefit the trade of any other company in the group. The reasons for conversion and the benefits expected to accrue from conversion related, he said, to the core business of the Halifax. Immediately relevant to the present issue are the answers given by Mr Foulds when questioned about the subsidiaries. He expressed the view that conversion of the building society into its new corporate form had no benefit for, or effect upon, the main subsidiaries. They were small in relation to the Building Society itself and they were already (and continue to be) separately regulated. Thus the restrictions imposed by the BSA did not apply to them to any material extent.

63. The Revenue's case is based on the proposition that the lifting of the BSA constraints had the consequential effect of removing constraints on the running and financing of the subsidiaries so leading to their organic growth and to the growth of the "holding company" operation of the Halifax; the Board's purposes, both actual and Mallalieu, had been to achieve those results. Consequently Mr Foulds was examined at some length and in detail on the view he had expressed. He was asked about the businesses of certain of

the subsidiaries and we now summarize the gist of his responses and add our comments.

64. Halifax Credit Cards Ltd's credit card business, put into a subsidiary because it had started as a joint venture with the Bank of Scotland, was regarded as part of the core bank business. It was, Mr Foulds said, in the course of growing from a "pretty low base": its value to the group was supportive in that it provided Halifax Building Society customers with a credit card facility and so kept them and their deposits within the Halifax empire and out of those of other credit card operators. It was attractive in its own right because it was a "high margin" business. We accept Mr Foulds' evidence in this regard. The fact that Halifax Credit Cards' business was supportive of the Halifax's core business implies that the real beneficiary of any development in the former company's business was the Halifax's own business. In any event there was no evidence to suggest that its business might be developed as a result of conversion; nor was there anything that indicated that development of its business was a reason for conversion.

65. Was the conversion expenditure incurred in part for the purposes of the trades of HLL (para 19(1) above), HMSL (para 19(2) above), HSL (para 19(10) above) all three of which were or remained in separate companies because BSA constraints required that they be kept out of the building society entity itself? Mr Foulds said that those trading activities were supportive of and were regarded as part of the core activities. Questioning for the Inland Revenue implied that a purpose of conversion was to provide those subsidiaries with better trading opportunities. We do not infer this. A benefit sought from conversion was to release the Halifax from BSA constraints. Future acquisitions and the development of future opportunities of that nature could therefore be absorbed directly into the core business of Halifax plc. Moreover there was no suggestion in any of the documentary evidence that the activities of those subsidiaries might be developed by further injections of capital.

66. To the same effect Mr Foulds was questioned about the Jersey and the Isle of Man subsidiaries (paragraph 19(3)). He replied that they were deposit takers whose balances were applied to fund and support the core building society business. In terms of net assets those two subsidiaries represented a relatively large part (some 12.2% as at 31 December 1996) of group net assets. Nonetheless, we are satisfied that the advantages of greater access to wholesale funding gained from conversion would not affect or improve the deposit taking operations of those subsidiaries. Nor do we see how that factor would affect the business of Banco Halifax Espana SA (paragraph 19(1)). We cannot therefore conclude that the purpose in incurring the conversion expenditure was in part to benefit those companies.

67. Halifax Financial Services Ltd was a holding company and its subsidiaries were Halifax Life, Halifax Unit Trust Management, Halifax Fund Management. All had been launched in January 1996. The sub-group took over the business of Leeds Life Assurance. Those activities were, Mr Foulds said, "important individually but that the sum of them was negligible … in comparison with the core business". The unit trust activity was there, said Mr Foulds, because when a customer sold unit trust products that had been bought from the Halifax in the first place, the proceeds were "more likely to come back into the Halifax coffers". It was, he said, a matter of "keeping control of your customer" (5/142): it was all part of the "core business", i.e. the taking of deposits (5/142). These companies and their businesses were kept separate because they had different regulators (e.g. the Financial Services Authority). We are aware of no reason why conversion of Halifax Building Society to a bank plc should affect, or be expected to affect, the affairs of those companies.

68. Halifax General Insurance Services Ltd had been set up to provide household and contents insurance to mortgage customers. This, Mr Foulds said, had been to keep the "commission" with the Halifax rather than allowing independent financial advisers to take it. Halifax General Services Ltd had been set up in January 1996 to develop a range of personal insurance products (underwritten by third party insurers) so giving Halifax, to use Mr Foulds' words, "control over all the factors that affect the quality of customer services … broadening customers' choice and the range of distribution …….". Sales of endowment policies linked to mortgages had taken place for many years. More recently these had been provided by Halifax Financial Services so as to secure the "embedded value" (i.e. the right to receive future premiums) to the Halifax group. Endowment policies were sold through the branch networks and were, save for a very small number, "linked to the mortgage process". A reason for purchasing Clerical & Medical was because of its own distribution network through financial advisers. Financial advisers generally produced 50% of the Halifax's mortgages. The Clerical Medical business therefore supported the mortgage business. It was, said Mr Foulds, a "very good business" in its own right and was not dependent on the Halifax "Treasury" for funding. It seems to us that none of the businesses referred to in this paragraph was or could reasonably have been expected to have been significantly affected by conversion. We have found no evidence to indicate that the expenditure on conversion was incurred for the purpose of those businesses.

69. The estate agency company was an "important producer" of mortgages, introducing one-eighth of all the mortgage business in 1996 (and 20% of the Northern Irish business in that year). It had been funded by equity capital. We cannot see that conversion and its attendant

benefits would have affected the estate agency business which was separately regulated anyway.

70. A leasing company had been established to provide leasing and hire purchase facilities. It widened the range of financial services provided by the group thereby stopping the loss of customers who might go elsewhere and change their loyalties. Mr Foulds (5/162) said of it that it was a very small part of the business but to the extent that it was there it had to be funded. Where it obtained funding raised by treasury, interest was paid at a rate that gave a margin to treasury (5/255). It was put to Mr Foulds in cross-examination that the purpose of conversion and of deregulation had been to allow the Halifax to take advantage of opportunities that arose and that the leasing operations were an example. Mr Foulds responded that those were ancillary benefits. We accept this.

71. The Transfer Document refers, in the introductory background to the reasons for conversion, to the recent expansion of the Halifax's "range of products and services in response to customers' changing borrowing and investment needs". Mr Foulds was asked whether this was referring to the group business. He agreed that the reference embraced everything. He said that the mortgage business was so very much larger than anything else. The other businesses were subsidiary. The mortgage business, he noted, represented over 80% of the £98 billion assets. He accepted (5/126) that a later reference to "complementary core business" referred to savings and current accounts, credit and debit cards, life assurance, unit trusts and other insurance products; they were, he agreed, "key areas of activity" that were small at the time but were likely to increase in importance.

72. We turn now to the board papers. Development of new business throughout the group as a whole had been referred to in a discussion paper produced to the board for its 20 September 1994 meeting; the paper referred to areas of activity of increasing importance and suggested that Halifax Life and Halifax Personal Banking could rival the building society in size and importance within a generation. Mr Foulds' response in cross examination was that that was a pious hope (5/129) and an overstatement. The development into these areas, which included unit trusts, PEPs and pensions was a response to what customers with cash savings accounts wanted (5/131). The reference to those other activities in the board paper was the only reference of any significance. Other references were very minor such as the note in the strategy meeting of February 1994 to the strengthening that bank status would give to the prospects for offshore funding subsidiaries. But the Isle of Man and the Channel Islands subsidiaries were, as we have already noted, recipients of deposits and were unlikely to be affected by the benefits of conversion, at least so far as access to wholesale funding

was concerned.

73. Mr Foulds was asked whether in all the discussions the Halifax board had been "looking at the core business of the group" (5/204). His immediate answer was "so it was". That has to be read in the light of his remarks (5/135) where he said -

"I mean, if you go through all these individual activities, they were all linked back into the core business one way and another. You see, if you have not worked in a building society, it is difficult to imagine that everybody thinks in terms of mortgages and savings and everything else is quite secondary, quite ancillary, and it is a mind set which in a rapidly changing commercial environment is not always an advantage, but that is how it was."

74. The treasury business, Mr Foulds said, needed the flexibility that bank status would give and building society status denied: such flexibility would enable access to wholesale funding sources so as to support the growth of the Halifax's mortgage business and to finance the other aspects of the group business such as leasing, unsecured lending, credit card financing and to provide capital for the estate agency business. Nonetheless, he said, by far the largest demand for wholesale funding arose from the effect of the greater needs of the core mortgage lending business; he anticipated that this demand would increase following the recovery from the recession in 1994 because the supply of retail deposits was, he said, expected to remain static.

75. Our review of the board papers, the oral evidence and the published documentation satisfies us that the evidence as a whole demonstrates that the disputed expenditure was not, as the Inland Revenue have claimed, incurred for the purpose of benefiting the subsidiaries or of benefiting the Halifax's holding company operation. We recognize that the activities of some of the subsidiaries were regarded as part of the core business of the Halifax and that the activities of those and others were directly supportive of the Halifax's core business. We recognize that the prosperity of the Halifax's core business would generate consequential increases in the scale of activities and profits of the subsidiaries. By the same token the Halifax's portfolio of holdings in subsidiaries, i.e. its holding company operation, would prosper in the same way as the individual businesses of the subsidiaries. But those were effects or consequences of the decision to convert and so to secure a release from the Building Societies Act regime; they were not purposes either real or Mallalieu.

Resolving the relationship between members/customers and customers who are not members

76. The third of the six factors taken into account by the

board of the Halifax in assessing the options and recommending conversion is explained in the Transfer Document as follows:

"The owner/customer relationship

Building societies have traditionally raised funds from their investing members for lending to borrowing members to purchase their homes. Investing and borrowing members are the owners of the Society.

Historically, the majority of customers of building societies were members. However, building societies are increasingly offering their customers products and services which do not confer membership, for example current accounts, credit cards, unsecured personal loans, life assurance, pensions and personal equity plans. This trend is expected to continue and the key growth areas for the Society are likely to be in those non-traditional but complementary businesses where customers do not have membership status.

The owner of the business is concerned with matters such as whether the business is being effectively and efficiently managed, whether the policies are in place to develop the business and whether the return received on his or her investment is adequate. In contrast, the concerns associated with being a customer of a business are different. The customer is concerned mainly with quality of service, convenience of distribution outlets, price and whether or not products meet his or her needs. Customers and owners have different priorities and the Board believes that this should be reflected in the constitution adopted by Halifax.

The capital of the Society has primarily been used to support its business of lending on mortgages. As the Society's business develops in other areas, an increasing amount of its capital will be applied to support its newer activities and to develop new product services. The Board considers it more appropriate that these developments should, in part, be funded by equity investors."

The argument for the Inland Revenue was that, to the extent that the resolution of this relationship was a purpose for which the expenditure on the conversion was incurred, this could not properly be characterized as a trade purpose. The purpose was to benefit the members in their capacities as proprietors. The Halifax accept that the resolution of the relationship between members who are customers and customers who are not members was a purpose for the conversion; but, they say, the manner by which the matter was resolved (through the mechanism of the issue of the shares) does not form part of this purpose.

77. Mr Foulds' evidence in this respect was directed at the

board's perception of the different priorities of members and customers. The members were the proprietors for the time being of the building society and of its reserves. The board considered that it had a fiduciary duty towards its members and should recognize their property interests in the building society's reserves and specifically should recognize that they held the reserves primarily in order to provide security for the members' savings. But, as is made clear by the extract from the Transfer Document set out above, the Halifax Building Society had developed its range of activities and had attracted non-members as customers, for example through its personal banking facilities and it had increasingly put those reserves to use as risk capital for non-mutual activities. The estate agency business was another example. The Halifax Building Society had used "mutual capital" to support a foray into a new business in the hopes of recruiting new borrowing members; and yet the nature of that new business had required them to act for sellers and not for the buyers whom they hoped to recruit. Mr Foulds said in the course of cross-examination (5/174) that he had seen conversion as the only way to "disentangle" the relationship.

78. In our view the purpose for incurring the disputed expenditure was, so far as that expenditure resolved the perceived tension between members who were customers and customers who were not members, a wholly trade purpose. The purpose and effect of the expenditure were, we think, to remove an impediment to the development of the Halifax's core business thereby enabling them to deal even-handedly with all classes of customers.

"Release" of Halifax's value to members

79. This factor taken into account by the board in reviewing their options and recommending conversion is expressed in the Transfer Document as follows:

"The board believes that the value of the Society should be released to members to manage as they see fit. Although this is not in itself a benefit to the Society or the successor company, it will give qualifying investing members and qualifying borrowing members the choice of ownership. These members can remain owners by keeping their shares, with or without remaining customers, or maintain only a customer relationship by selling their shares. "

The Inland Revenue contend that this was a purpose and thus the expenditure was incurred for the purpose of benefiting the members and not wholly and exclusively for the purposes of the Halifax Building Society's trade. The Halifax argue that releasing value to members was not a purpose of the expenditure; it was a consequence of the decision to convert.

80. Save for those members who received statutory cash

bonuses, which are separately dealt with later, there was no release by the Halifax of its assets to the members. The reserves of the Halifax Building Society were transferred to Halifax plc, as part of the conversion process, and in return shares were issued direct to the members. The moneys subscribed remained in the Halifax Plc. The members received marketable shares whose values reflected the underlying value of Halifax plc. The fact that value would be released to members was fully recognized by the board of the Halifax Building Society. It had been "in everybody's mind" said Mr Foulds (5/223). The merger discussion notes record that the Leeds board were "motivated to release shareholder value in one way or another" (19 July 1994), "still wished to ensure that their members received value in the future" (22 July) and "would be considering various alternatives for realizing shareholder values within an industry wide scenario" (22 August). A discussion paper presented at the 20 September meeting of the Halifax Building Society board said - "If we want a merger we either accept pressure to release value through a subsequent conversion or we convert then acquire"; this matter was touched on at the board meeting itself but no conclusions were reached. It arose again when on 21 September the Board reviewed their fiduciary duties with Linklaters & Paines (solicitors): the advice is recorded as requiring them to assess their options "for the benefit of the Society" and in this respect "the interests of the entity (and its mission) could supersede any duty to release cash to members" because their duty was "to run the business, not to realize the assets of an ongoing business".

81. The 11 October board meeting continued the debate about conversion to plc and Mr Foulds is recorded in the minutes as having said-

"The proposition that a move from mutual to plc status was "inexorable" was challenged. The arguments for inexorability were thought to rest on size, diversity and wholesale funding, but there was a new and very relevant factor: members now knew, through Lloyds/C&G, that a substantial release of value was possible. Members would, therefore, implicitly press for conversion or acquisition. Only if we could redefine mutuality to make it more attractive to members than the release-of-value option would we be able to resist conversion. This was unlikely."

The decision to convert was taken at the 19 October board meeting. A paper prepared by S G Warburg & Co reviewed the options and implications of the choice between staying mutual and converting. Among the many "Market Considerations" is the following passage:

"The timing of the flotation in the economic cycle and the impact on long term value per member need not necessarily be of great importance if members take up their

entitlements in full and retain their shares."

Other than those references we can find nothing of any significance that suggests that a reason for the decision to convert and consequently a purpose for incurring the conversion expenditure was to release value to the members. Mr Foulds in cross-examination insisted that "business reasons" in the sense of the development of the business and not the release of cash had been at the core of the discussions (5/223). He refused to accept that release of value to members had even been a subsidiary reason (5/248).

82. In evidence Mr Foulds said that at the time there had been no media pressure inciting members to push for conversion. There had been no carpet-bagging; that had followed the Halifax conversion. Nonetheless, Mr Foulds conceded, "if you want to get the votes you have to bribe the voters" (5/245). This, we note, is against the background that the Halifax Board had decided to take the "existing company" route which, as we have already explained, requires that the "savings" members' vote is to be not only a special majority of 75% of those voting but also that those voting in favour must constitute not less than 50% of the members qualified to vote (by number) or 90% (by value) of shares held.

83. Our conclusion from the evidence on this topic is that release of value to members was not a reason for the decision to convert; still less was it a purpose for incurring the expenditure. At most it was a factor that was taken into account by those who had to decide whether to recommend conversion. It was taken into account essentially for this reason. The members had interests in the underlying reserves and they had votes. If conversion were to take place their interests had to be redefined and expressed as shares in the plc; and if they did not qualify to become shareholders they had to be provided with compensation in the form of statutory cash bonuses. Their votes were essential if conversion, seen by the Board as being in the best interest of the business, were to be effected. Consequently the "release of value" was perceived by the members to be an advantage and a factor of great significance.

84. The Inland Revenue, at one stage, contended that the expenditure had not been incurred wholly and exclusively for the purposes of the trade because it had been incurred to produce equity holders in circumstances where mutuality had become outmoded for an entity of the size of the Halifax Building Society. This, as we see it, is another way of saying that the purpose of the expenditure was to benefit the proprietors with the result that it could not be said to have been wholly and exclusively laid out for the purposes of the trade. We do not accept this. The redefining of the interests of the members of the building

society as shares in the plc was an inevitable consequence of conversion. The purpose for the expenditure was, however, the wholly business purpose of obtaining a release from the BSA constraints with the attendant benefits that that produced, such as greater access to wholesale funding. But the expenditure was not, we think, incurred for the purposes of making the members into equity shareholders.

Merger with the Leeds

85. The final contention of the Inland Revenue on the "wholly and exclusively" issue was that because a purpose of the conversion was to secure the merger with the Leeds, the related expenditure was not incurred wholly and exclusively for the purposes of the business of the Halifax Building Society.

86. The merger with the Leeds was not expressed in the Transfer Document as a reason for conversion. Had it been any part of the "rationale" for the conversion, the Building Societies Commission's Guidance Notes on Conversion Procedures (paragraphs 2.1-4), would have required disclosure of this factor in the Transfer Document. The Halifax, Mr Foulds told us, took advice from its lawyers, Linklaters & Paines, as to what should be set out as reasons for and considerations behind the conversion; and the Building Societies Commission supervised the Transfer Document with meticulous care.

87. Mr Foulds explained the background. The Halifax had decided that it needed to increase its size by a possible merger. Close links with the Leeds had led to discussions at a high level in March 1994. Then the Cheltenham & Gloucester Building Society announced that it was to be acquired for cash by Lloyds Bank. Negotiations between the Halifax and the Leeds board proceeded with the Leeds board taking the negotiating stand that they would only merge with the Halifax against a binding commitment that there would thereafter be a conversion of the enlarged society. The board of the Halifax had by then, following the outcome of the February 1994 strategy review, identified conversion in the medium term as a viable option. Nonetheless the Halifax board were, at the start of the discussions with the Leeds board, reluctant to make any commitment to convert.

88. The notes of the meeting of the directors of the two building societies on 7 July 1994 recorded Mr Foulds as recognizing that the Halifax needed to reconsider its mutual status in the light of "future strategy, pressure on funding re counter party funding in the money and capital markets, public and regulatory pressure re the distribution of surplus profits, etc." A meeting of 19 July records that Leeds "were clearly motivated to release shareholder value in some way or another". The minute of a joint meeting of three board

members (the same day) records the Leeds director stating that Leeds would require some assurance that conversion "was likely to follow merger". The minute of a joint meeting of 22 July shows the Halifax directors acknowledging that the Leeds would only be persuaded to adopt conversion if it were coupled with a private statement from the Halifax's directors "that conversion within say five years of merger had a better than 50:50 chance". Mr Foulds is recorded, at a meeting on 22 July, as expressing the view -

"There is a groundswell of opinion from certain quarters of the board that the subject of constitution should now be revisited and, in his opinion, there will be no resistance to this if there were compelling reasons. Albeit he did reiterate that today's reasons for change would not be the same as those which took the Abbey National down the plc route.

He believed that the overwhelming pressure would arise from the group's limited ability to access the national and international capital and money markets in its present mutual building society form. In simple terms, the Halifax was starting to outgrow its sector. He further commented that a merger with Leeds would create a new business some 30% larger than the Halifax in its present form. This would exacerbate the problem just described and, in all likelihood, accelerate any decision to change the constitution of its new business. ... all of the issues described above led him to believe that a change of constitution will come about for sound business reasons and, as a consequence, the status of mutuality could never be defended on ideological grounds."

At a further meeting on 22 August the finance director of the Halifax said that -

"The principle of conversion would be embraced if it was for the right business reasons" and "no commitment could be given".

89. Finally on 26 August Mr Foulds wrote to the Vice Chairman of the Leeds. An

extract from this letter reads as follows:

"I believe it might be helpful if I set down my perception of the attitude of the Halifax Board towards conversion.

When we considered this option first in 1988 the discussion was driven by concerns about access to capital and powers. The Board decided at that juncture that the business case was not sufficiently compelling to take such a major and irreversible step. Conversion has, however, been the subject of regular reconsideration. In recent months, it has come more sharply into focus because of growing concern about our ability to raise the quantum of funds, which we believe the continued growth of the business will require us

to find from world capital markets.

At the time of writing the pressure of the change from this source seemed inexorable and particularly so in the context of a merger. Regulatory change might help to contain the problem, as might the creation of a constitution for a mutual bank. The latter however seems an unlikely source of relief given its novelty and the need to secure the Parliamentary time to secure the necessary legislation.

Mutuality served our members well throughout our long history but the present Board's attitude is essentially pragmatic rather than dogmatic. Providing the evolving business case is made, I am confident that our Board would be ready to propose a timely constitutional change to enable us to improve further the service and the value we provide to our customers and members."

90. The Board of the Halifax then held a series of meetings at which they debated the advantages and disadvantages of staying mutual. Mr Foulds mentioned that a recent meeting with the Leeds had "indicated that they felt it impossible to sell to their members a deal which did not release value". The Halifax board discussions proceeded almost without reference to the possible merger with the Leeds. At an informal meeting on 20 September Mr Foulds reminded the directors that a decision to convert did not necessarily involve a deal with the Leeds. The discussion paper debated at that meeting identified the Leeds merger as a factor to be taken into account in reaching the decision to convert or stay mutual. Thereafter the Halifax Board meetings focused on the business implications of conversion with or without merger; merger is not referred to as a condition of conversion or vice or versa. For instance, at the 19 October meeting of the Halifax board Mr Foulds said that the board should nonetheless consider a stand-alone conversion. This did not have to be dependent upon whether members would be "better off" with the Halifax conversion alone or with Halifax plus the Leeds. After an extensive discussion Mr Foulds is noted as having reported "the unanimous wish of the Board to pursue discussions with the Leeds and the acceptance, with conviction, that conversion will be a consequence." The press release of the Halifax and the Leeds announcing their intention to merge and subsequently to convert was issued on 25 November 1994.

91. In the course of cross-examination Mr Foulds stated that conversion had not been "off the table" since 1988; it had come to a head as the result of the merger discussion but he said that he was satisfied that had they not converted at that time, it would have taken place probably a year later (5/208). The business case for merger and the release of value to members following conversion had been driven by business reasons (5/222-3); conversion had been a consequence of the merger but as was not a reason for it

(5/223). Mr Foulds emphasized that the decision to recommend the merger had been conditional upon their agreeing at some future date to convert; but "the things that had driven the merger were nothing to do with conversion, nothing to do with releasing value" (5/323). Moreover, he said (5/204), although the Halifax board felt it had a "commitment" to convert following the decision to merge with the Leeds "it might have stepped back from that commitment if market conditions had changed dramatically".

92. In evidence Mr Foulds expressed the view, which was not questioned, that for the Halifax to have decided to convert solely or even mainly to facilitate the "absorption" of a business one quarter its size would have been commercially indefensible; and the Halifax's decision had not been based on that consideration.

93. The evidence shows that considerations relating to the Leeds merger precipitated the decision of the Halifax board to take the conversion route and consequently to incur the disputed expenditure. They recommended the merger knowing that it would lead to conversion. Nonetheless, the decision to convert was based on considerations of the Halifax's trade; these were the really significant considerations. The decision to convert and therefore the purpose for incurring the expenditure were not in our view wholly or partly to secure the merger with Leeds.

The statutory cash bonuses : was the expenditure laid out wholly and exclusively for the purposes of the trade?

94. Sections 97 to 102 of the BSA contain the legislative provisions which apply when a building society transfers the whole of its business to a commercial company. Section 100(1) provides that the terms of such transfer may include provision for part of the funds of the society or its successor to be distributed among members of the society or other rights in relation to shares in the successor conferred on members of the society. Thus the distribution of shares to the members was made under this provision and was discretionary. Section 100(2)(b) provides that the terms of the transfer must confer a right to a distribution of funds by way of bonus on every qualifying member of the society equal to the relevant proportion of the value of the qualifying shares held by him in the society. Section 100(4) provides that a "qualifying member" is a member who held shares on the qualifying day and was not eligible to vote on the transfer resolution and the "relevant proportion" is the proportion which the society's reserves bear to the total liability to its members in respect of shares. Thus section 100(2)(b) is mandatory and provides for an investing member who did not have the right to vote on the transfer to receive a distribution from the reserves of the building society equal to his share of the reserves. For the Halifax the percentage of reserves held by qualifying members was

in the region of 9.4%. It is these distributions which are referred to as the statutory cash bonuses.

95. The members of the Halifax who were not eligible to vote on the transfer, and who were, therefore, entitled to a statutory cash bonus, were minors and members with credit balances of less than £100. Members with credit balances of less than £100 and minors who were members for less than two years were not entitled to participate in a winding up. However, minors with credit balances in excess of £1000 who had been members for more than two years were entitled to participate on a winding up.

96. The Inland Revenue contend that no deduction is available for these payments. To the extent that they were expenditure for the purpose of releasing value to members, they were paid for a non-trade purpose. Further, it is argued, they are to be treated as payments of profit already earned, rather than as expenditure incurred in earning the profits.

97. We are against the Inland Revenue on the first argument. Our reasons are essentially those given in relation to the "release of value" issue dealt with above, The Inland Revenue's second argument is that because the payments are the compulsory allocation of fruits of the trade and other activities of the building society (such as receiving dividends from subsidiaries), they cannot properly be said to have been laid out for the purposes of earning profits. We cannot accept this. These payments were made as part of the expenditure incurred for the purposes of conversion and consequently for the purpose of enabling the building society's business to be conducted more effectively. They were laid out to enable Halifax to earn profits in the future. Nor were they in the same category as the legal and accountancy expenditure incurred by Smith's Potato Estates Ltd (in Smith's Potato Estates v Bolland [1948] AC 508 (HL)) in contesting a tax assessment which were disallowed on the grounds that they were not incurred in order to earn the profit. For those reasons we are satisfied that the statutory cash bonuses are not to be disallowed on the grounds that they were not laid out wholly and exclusively for the purposes of the trade. For all those reasons we are satisfied that all the conversion expenditure is allowable - only so long as it is not of a capital nature, a point which we now turn

The capital or revenue expenditure issue

98. Section 18(1)(a)(iii) of the Taxes Act provides that tax shall be charged under Schedule D in respect of the annual profits or gains arising to any person from any trade, profession or vocation.

The relevant parts of section 74 of the Taxes Act provide:

"(1) Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of- ...

(f) any capital withdrawn from, or any sum employed or intended to be employed as capital in, the trade, profession or vocation, ..".

99. The issue here is whether the disputed expenditure is, as the Inland Revenue argues, not deductible on the grounds that it (i.e. the costs of conversion and the statutory cash bonuses) is of a capital nature.

100. Oral expert evidence was given on behalf of the Halifax by Mr Ronald McNeill Paterson who also put in a written statement of evidence. Mr Paterson has been a member of the Institute of Chartered Accountants of Scotland since 1974 and a member of its Council since 1998. He joined one of the predecessor firms of Messrs Ernst & Young in 1970 and was a partner from 1982 to June 1999. He was a member of the UK Accounting Standards Committee between 1987 and 1990 and from 1991 to 1999 was a member of the Urgent Issues Task Force of the Accounting Standards Board. He was also the UK representative on the Improvements Working Party of the International Accounting Standards Committee. Mr Paterson now practises as an independent consultant on financial reporting matters.

101. Oral evidence was given on behalf of the Inland Revenue by Mr T C Carne who also put in a written statement of evidence. For the last eight years Mr Carne has been the Advisory Accountant to the Board of Inland Revenue. He is a Fellow of the Institute of Chartered Accountants in England and Wales, having been admitted a member in 1969. After qualifying as a Chartered Accountant Mr Carne spent nine years in private practice and industry before joining the Inland Revenue in 1978.

102. On 27 January 2000, after the exchange of their written statements of evidence, Mr Paterson and Mr Carne met and produced a joint memorandum which set out their areas of agreement. The joint memorandum was also put in evidence in the appeal.

The facts relevant to the capital or revenue expenditure issue

The accounts

103. The income and expenditure account of the building society for the eleven month period ending on 31 December 1996 (the period before the conversion) included conversion costs provision of £152.9M as an exceptional item of administrative expenses in the calculation of

operating profit. This figure was carried forward to the group income and expenditure account. The consolidated profit and loss account for the period ending on 31 December 1997 (the period after conversion) showed an additional £18.1M for conversion costs, again as an exceptional item of administrative expenses in the calculation of the operating profit. Thus the total amount of the costs of conversion was £171M.

104. The balance sheet of the building society for the 11 month period ending on 31 December 1996 (the period before conversion) showed the assets, including tangible assets, and liabilities. There were three main liabilities, namely: shares, deposits and loans; other liabilities; and reserves. Shares, deposits and loans included retail and non-retail funds and deposits; other liabilities included subordinated liabilities (bonds and notes) and subscribed capital (permanent interest bearing shares); the reserves amounted to £6,719.9M and were the accumulated amounts brought forward from the profit and loss account from previous years increased by the profit for the current year.. The reserves, less some deductions, were carried forward into the group accounts which showed reserves of £6,605.5M.

105. The consolidated balance sheet for the year ending on 31 December 1997 (the period after conversion) also showed assets and liabilities. The liabilities no longer included any reserves but instead had a new sub-heading of "equity shareholders' funds." This comprised three items, namely: called up share capital of £503.9M; share premium account of £70.1M; and profit and loss account of £6,641.4M making a total of £7,215.4M. The figure of £6,641.4M for the profit and loss account was derived from the balance carried forward from the previous year of £6,605.4M; the addition of profit retained for the current year of £649.9M; the deduction of the statutory cash bonuses of £14.9M; the deduction of the share capitalisation of £573.9M (now included separately as share capital and share premium account) and some other minor adjustments. (A240 note 33).

The statutory cash bonuses

106. The requirements of the BSA so far as they relate to statutory cash bonuses are summarized in paragraphs 94 and 95 above.

107. Part C section 1.14.2 of the Transfer Document indicates that persons who received the statutory cash bonus were liable to capital gains tax on that payment.

The accountancy treatment

108. The Halifax accounted for its conversion from a building society to a public limited company by using the

principles of merger accounting in order to give a true and fair view.

109. Mr Paterson gave evidence, which we accept, that the conversion fell within the definition of "business combinations" because it involved the Halifax obtaining control of the net assets and operations of the former building society. That invoked the provisions of Financial Reporting Standard 6 (FRS 6) which required such a transaction to be accounted for by using either acquisition accounting or merger accounting. The essential difference between acquisition accounting and merger accounting was that merger accounting sought to preserve the continuity of the previous accounting whereas acquisition accounting did not. FRS 6 provided that merger accounting could be used not only for mergers as such, but also for group reconstructions which were simply internal arrangements involving no change to the overall ownership of the business. Although in the present appeal there were slight changes to the overall ownership of the business they were not of such a magnitude as to disturb the conclusion that the transactions were fundamentally group reconstructions for which merger accounting was the only sensible method. Mr Carne agreed that the substance of the transactions required merger accounting to be used to show a true and fair view.

110 The conversion costs were charged to the profit and loss account and deducted in the computation of the operating profit. They were shown as exceptional costs of a revenue nature because of their size and incidence. Both Mr Paterson and Mr Carne agreed that this was the correct accountancy treatment and accorded with FRS 3; it would not have been correct to include them in the category of exceptional items which are required to be shown after operating profit, such as costs of a fundamental re-organisation or restructuring having a material effect on the nature and focus of the reporting entity's operations. They also both agreed that the relevant accounting principles dictated that the conversion expenditure could not be recognised as an asset.

111. The evidence of Mr Paterson, which we accept, was that, with the possible exception of the costs of information technology, no part of the conversion costs could have been regarded as capital expenditure under the ordinary principles of commercial accountancy. They did not give rise to any tangible asset. As far as intangible assets were concerned Mr Paterson considered five possibilities. First, he did not consider that the conversion expenditure could be said to be the costs of gaining authorisation under the Banking Act 1987. Secondly, he did not see how the possession of an accurate register of members could ever be seen as an asset in accountancy terms. Thirdly, the new corporate structure could not conceivably qualify to be recognised as an asset. Fourthly, the freedom from

restrictions could not be regarded as an asset in accounting terms. And, finally, in his view the Halifax's profit making apparatus had little to do with its constitution and much to do with its brands, products, workforce, distribution networks, and management systems. Not only did the expenditure not relate to such items but in any event such items did not feature on balance sheets under the ordinary principles of commercial accounting. Mr Paterson concluded that, if the expenditure had been capitalised as an asset, the auditors would have had to give an adverse opinion on the accounts which would not have given a true and fair view of the state of affairs as the profit and loss account would have overstated the true profits of the Halifax.

112. The statutory cash bonuses were not shown as a deduction in the profit and loss account but were shown as a deduction from the profit and loss reserve in the balance sheet within the reconciliation of movements in shareholders' funds. This would accord with the conclusion that the payments were distributions to owners in their capacity as owners. Mr Paterson did not disagree with this treatment but did not necessarily rule out the alternative treatment of including these costs with the other conversion expenditure in the profit and loss account. He said that his final view would depend upon whether the recipients were not only owners of the building society but were owners in commercial substance. They did not enjoy the right to vote and the transfer document at page 31 related the entitlement to free shares to the right to vote and the right to vote was the most tangible evidence of ownership of the building society. Mr Carne, however, was of the view that the factor which determined ownership was the right to participate in a dissolution. If the recipients did not enjoy that right then he could see an argument that they were not owners and so the costs of the bonuses could have been charged to the profit and loss account.

The arguments relevant to the capital or revenue expenditure issue

113. The arguments of the parties relevant to the capital or revenue expenditure issue raised a number of distinct questions which we have identified as:

(1) What is the correct approach to the interpretation of section 74?

(2) What weight should be given to the ordinary principles of commercial accounting?

(3) Is it necessary to identify a capital asset on the balance sheet?

(4) If so, was there such an asset?

(5) What are the principles identified by the authorities?

(6) What is the relevance of the purpose of the expenditure?

(7) What was the expenditure calculated to effect from a practical and business point of view?

(8) Should the costs of the abortive treasury bank and/or the costs of Halifax Share Dealing and/or the costs of Halifax Single Company PEP be treated differently?

(9) Should the statutory cash bonuses be treated differently?

114. We consider each of these questions separately.

(1) - What is the correct approach to the interpretation of section 74?

115. The first question concerns the correct approach to the interpretation of section 74.

116. The Halifax argued that profits had first to be determined in accordance with the generally accepted principles of commercial accountancy and then adjusted in the light of any relevant statutory provision. Reliance was placed on Gallagher v Jones (1994) 66 TC 77 and Herbert Smith v Honour [1999] STC 173 and British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205, where there was no accounting evidence at all, was distinguished.

117. For the Inland Revenue it was argued that, before applying the provisions of section 74(1)(f), it was first necessary to consider whether the expenditure was to be charged against income in computing the profits or gains. Only after that exercise had been completed was the specific disallowance in section 74(1)(f) applied. Atherton at page 210 was cited and reference was made to the judgment of Lord Buckmaster at page 224. It was accepted that none of the expenditure represented a "sum employed or intended to be employed as capital in" the business within the meaning of section 74(1)(f) as that was represented by the free shares issued to the shareholders the cost of which was not in issue in the appeal.

118 In approaching this argument we have been assisted by the judgment of Lord Templeman in Beauchamp v F W Woolworth plc (1989) 61 TC 542 where he said at page 574C:

"My Lords, section 1 of the Income and Corporation Taxes Act 1970, now s 1 of the Act of 1988 ... directs ... that income tax shall be charged in respect of profits described in Schedule D set out in s 108 of the Act of 1970 [now

section 18 of the 1988 Act]. That section directs ... that tax shall be charged in respect of the annual profits arising or accruing to any person ... from any trade. The expression "profits" is not defined, and there is no express provision for the deduction of the expenses incurred in earning profits, but it is only possible to arrive at the computation of profits of a trade after setting against the receipts the expenditure necessary to earn them according to the ordinary principles of commercial accounting ... The expression "annual profits" confirms that income tax is to be charged on profits of an income nature as opposed to capital profits. ... Moreover, by section 130(f) of the Act [now section 74(1)(f) of the 1988 Act], in computing the amount of the profits of a trade, no sum shall be deducted in respect of any sum employed or intended to be employed as capital .... It follows that while expenses incurred in earning profits may be deducted for the purpose of assessing income tax on the profits of a trade, such expenses as may be incurred in respect of capital transactions are not so deductible. ...The question which arises in the present case is whether an expense was incurred by a trader in earning profits, or was incurred in the course of a capital transaction."

119. Thus it is first necessary to ascertain the annual profits of the trade, as required by section 18(1)(a)(iii). To do that one has to set against the receipts of the trade the expenditure necessary to earn them according to the ordinary principles of commercial accounting. That exercise would normally exclude the deduction of expenses relating to capital transactions because such expenses would not be incurred in earning profits and would not be deductible in accordance with the ordinary principles of commercial accounting. Having computed the annual profits on that basis it is then necessary to go on and to exclude the matters mentioned in section 74(1) (or any other statutory provision).

120. As far as is relevant in this appeal, section 74(1)(f) excludes both capital withdrawn from the trade and also any sum employed or intended to be employed as capital in the trade. The Revenue accepted that neither the conversion costs nor the statutory cash bonuses were sums employed or intended to be employed in the trade. Accordingly, the questions which remain for us to consider are: first, whether the costs of conversion and/or the statutory cash bonuses should be set against the receipts of the trade for the purpose of computing profits; and, if so, whether they are capital withdrawn from the trade and thus specifically excluded from deduction by section 74(1)(f).

121. In his judgment in Beauchamp, referred to above, Lord Templeman said:

"...it is only possible to arrive at the computation of profits

of a trade after setting against the receipts the expenditure necessary to earn them according to the ordinary principles of commercial accounting (emphasis added)."

122. That leads us to the next question addressed by the arguments of the parties which concerns the weight to be given to the ordinary principles of commercial accounting.

(2) - What weight should be given to the ordinary principles of commercial accounting ?

123. For the Halifax it was argued that many of the authorities were decided before the principles of sound commercial accounting became codified and many of the principles derived from the authorities were now found in the accountancy code which governed the manner of recording the business effect of transactions. The conclusion as to whether a transaction was of a capital or a revenue nature would normally be arrived at by the application of the principles of sound commercial accountancy. Odeon Associated Theatres v Jones (1971) 48 TC 257 and Heather v P-E Consulting Group Ltd (1973) 48 TC 293 were cited and ECC Quarries v Watkis (1975) 51 TC 153 where there was no evidence of the proper accounting treatment, was distinguished.

124. For the Inland Revenue it was argued that a decision as to whether expenditure was capital or revenue was a matter of law and not a matter of commercial accounting practice and accountancy practice was not determinative. All the authorities on this point concerned the time when income should be taxed and not the distinction between capital and revenue expenditure. Reference was made to Gallagher v Jones and Herbert Smith. In any event, it was argued, Herbert Smith had been wrongly decided. ECC Quarries was cited. The courts had always made it clear that the decision was one for them and not for accountants and for this proposition Heather was cited.

125. In considering the arguments of the parties we have first referred to the authorities cited to us in order to identify the principles which we should apply.

126. In Odeon (1971) the appellant purchased a number of theatres shortly after the war of 1939-45. The theatres were in a poor state of repair because work other than essential maintenance had been prohibited during the war.

The appellant carried out the deferred repairs and the cost was charged in its entirety to trading account, the evidence being that that was the standard practice of commercial accounting. At first instance Pennycuick J said at page 272I:

"First, one must ascertain the profits of the trade in accordance with ordinary principles of commercial accountancy. That, of course, involves the bringing in as items of expenditure such items as would be treated as proper items of expenditure in a revenue account made up in accordance with the ordinary principles of commercial accountancy. Secondly, one must adjust this account by reference to the express prohibitions contained in the relevant Statute, this being now contained in s.137 of the Income Tax Act 1952. That is to say, an item of expenditure, even if it would be allowed as a deduction in accordance with the ordinary principles of commercial accountancy, must be struck out if it falls within any of those statutory prohibitions."

127. And later at page 273E:

"The concern of the court in this connection is to ascertain the true profit of the taxpayer. That and nothing else, apart from the express statutory adjustments, is the subject of taxation in respect of a trade. In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy. I use the word "correct" deliberately. In order to ascertain what are the correct principles it has recourse to the evidence of accountants. That evidence is conclusive on the practice of accountants in the sense of the principles on which accountants act in practice. That is a question of pure fact, but the Court itself has to make a final decision as to whether the practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proportion of cases the Court will agree with the accountants, but it will not necessarily do so. ... At the end of the day the Court must determine what is the correct principle of commercial accountancy to be applied. Having done so, it will ascertain the true profit of the trade according to that principle, and the profit so ascertained is the subject of taxation."

128. Pennycuick J went on to consider that, in that appeal, the evidence of the accountants was that the disputed expenditure should be dealt with as a charge to revenue and he saw no reason to conclude that that principle was incorrect. That approach was upheld by the Court of Appeal

129. Odeon therefore is authority for the principle that the profits of a trade should be computed for the purposes of section 18 in accordance with the ordinary principles of commercial accounting. Those principles are a matter for the evidence of accountants but the court still has to decide

whether they correspond to the correct principles of commercial accounting. Although in the vast majority of cases the Court will agree with the accountants, they may not always do so. When the profits have been calculated in this way then the specific statutory adjustments have to be made, which in this appeal means that section 74(1)(f) has to be applied.

130. In Heather (1972) a company carried on the business of management consultants. Following the death of a principal shareholder the staff became concerned at the prospect of control being exercised by shareholders with no professional qualifications. A scheme was set up to give the staff an opportunity to purchase a stake in the company and to remove the possibility of outside interference. A trust was established and the articles of association of the company were amended to provide that any shares available for transfer should be offered to the trustees. The company undertook to pay to the trustees 10% of its gross profit for the purchase of shares. The evidence of an accountant was that the cost to the company of securing and retaining the services of employees was usually revenue expenditure and that as "employee goodwill" could not be evaluated, expenditure for that purpose was normally written off. In the Court of Appeal Lord Denning MR at page 322C considered the weight given to the evidence of the accountant and said at page 322F :

"The Courts have always been assisted greatly by the evidence of accountants. Their practice should be given due weight; but the Courts have never regarded themselves as being bound by it. It would be wrong to do so. The question of what is capital and what is revenue is a question of law for the Courts. They are not to be deflected from their true course by the evidence of accountants, however eminent. However, in the end the Judge agreed with the Commissioners - as I agree with them - that the payments here were revenue and not capital expenditure."

131. Thus Heather confirmed the principles established in Odeon.

132. The Inland Revenue relied upon ECC Quarries (1975). In that appeal a company incurred expenditure in connection with unsuccessful applications for planning permission to extract sand and gravel. The permissions would have enabled the company's activities to be pursued until well after the year 2000. The expenditure was treated as revenue expenditure in the company's accounts. The unchallenged evidence of both the company's auditor and of an independent accountant was that this treatment was in accordance with the general principles of commercial accounting. The Special Commissioners dismissed the appeal; they accepted that many accountants had been debiting costs of planning applications to revenue account but said that the correctness of that practice for tax

purposes had to stand or fall by the correctness of their decision. In the High Court Brightman J reviewed the authorities and concluded that, on common sense principles, the expenditure was of a capital and not of an income nature. He then went on to consider whether he ought to be persuaded to a different view in the light of the accountancy evidence. He noted that there was no finding of the Special Commissioners either accepting or rejecting that evidence and there was also no finding by the Special Commissioners as to established accountancy practice. He concluded that he had formed his view on the basis of the decided cases that the expenditure was of a capital nature and that the accountancy evidence was not sufficient to persuade him to alter that view.

133. In our view ECC Quarries confirms the principle established in Odeon that the ordinary principles of commercial accountancy are a matter for the evidence of accountants but that the court still has to decide whether they correspond to the correct principles of commercial accountancy. Although in the vast majority of cases the Court will agree with the accountants in ECC Quarries, it did not do so. A relevant factor was that there had been no finding by the Special Commissioners accepting or rejecting the accountancy evidence and no finding as to established accountancy practice.

134. In Gallagher v Jones (1993) the taxpayer leased some boats for 24 months on payment of a lump sum followed by 17 monthly payments and thereafter for 21 years at £5 per year. The accounts treated as expenditure the lump sum payment and five of the monthly payments. It was agreed that the payments were of a revenue and not of a capital nature. The Inland Revenue argued that the total amount payable in the primary period should be spread over the whole of that period following the ordinary principles of commercial accounting embodied in Statements of Standard Accounting Practice SSAP 2 and SSAP 21. The Special Commissioner accepted the uncontradicted accountancy evidence given on behalf of the Inland Revenue and dismissed the appeal. In the Court of Appeal Sir Thomas Bingham MR said at page 555g:

"Subject to any express or implied statutory rule, of which there is none here, the ordinary way to ascertain the profits or losses of a business is to apply the ordinary principles of commercial accountancy. That is the very purpose for which such principles are formulated. As has often been pointed out, such principles are not static: they may be modified, refined and elaborated over time as circumstances change and accounting insights sharpen. But so long as such principles remain current and generally accepted they provide the surest answer to the question which the legislation requires to be answered. ... I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of

commercial accountancy which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business."

135. Gallagher v Jones did not concern the issue as to whether expenditure was capital or revenue in nature but rather concerned the issue as to the time when a deduction should be claimed. Nevertheless, the words of Sir Thomas Bingham are general in nature and confirm the principles established in Odeon. He accepted that there would be some cases where the ordinary principles of commercial accountancy would be "inapt to determine the true profits or losses of the business".

136. We note that section 42 of the Finance Act 1998 provides that, for the purpose of Case I or Case II of Schedule D, the profits of a trade must be computed on an accounting basis which gives a true and fair view, subject to any adjustment required or authorised by law in computing profits for those purposes. However, the section only applies to periods of account after 6 April 1999 and so is not relevant in this appeal. Nevertheless, the enactment is of interest.

137. From the authorities which we have considered we derive the principles that the profits of a trade should be computed for the purposes of section 18 in accordance with the ordinary principles of commercial accounting. Those principles are a matter for the evidence of accountants but the court still has to decide whether they correspond to the correct principles of commercial accountancy. Although, in the vast majority of cases, the Court will agree with the accountants they may not always do so. When the profits have been calculated in this way then the specific statutory adjustments have to be made which in this appeal means that section 74(1)(f) has to be applied.

138. Applying those principles to the facts of the present appeal, and to the costs of conversion only at this stage, we find that both of the witnesses who gave evidence as to accountancy practice agreed that the costs of conversion should be a deduction from operating profit in the profit and loss account. They both relied on the fact that no asset appeared on the balance sheet. We accept that evidence and find that to be the established accountancy practice. That points to the conclusion that the costs of conversion were of a revenue and not a capital nature. However, we still have to consider whether the general rules of commercial accounting are the correct principles of commercial accountancy and that leads us to the next question raised by the arguments of the parties, namely, whether it is necessary to identify a capital asset on the balance sheet.

(3) - Is it necessary to identify a capital asset on the balance sheet?

139. For the Appellant it was argued that the agreed accountancy evidence was that, if it was not possible to identify an asset for inclusion in the balance sheet, then there was no capital expenditure. For that reason the conversion costs were correctly treated as a deduction in the calculation of operating profit and they were not treated as expenditure on a fundamental re-organisation or re-structuring. This approach corresponded with the identifiable asset test found in the authorities. There was no authority for the view that there could be a capital asset for tax purposes if it did not appear on the balance sheet. Tucker v Granada Motorway Services Ltd (1979) 53 TC 92 at page 108f and CIR v Wattie [1998] STC 1160 were cited. Atherton, where the expenditure was treated as if it were an asset of the company, was distinguished; Van den Berghs Ltd v Clark (1935) 19 TC 390, which involved a change to the profit earning structure rather than the constitutional framework, and J B Kealy v O'Mara (Limerick) Ltd [1942] Irish Tax Reports 642, which decided that the costs of incorporating a new parent company were capital in nature because it merged three companies into one group were also distinguished. If the Halifax had incorporated a new subsidiary the shares would have been assets on its balance sheet whereas the shares subscribed for by the Halifax Building Society in the public limited company and given to the members were not assets in the hands of the Halifax Building Society but were assets in the hands of the shareholders and a liability of the Building Society.

140. For the Inland Revenue it was argued that it was not necessary to show the acquisition of an asset which appeared on the balance sheet and the pension fund in Atherton (1926) and the lease in Tucker (1979) were cited. These were items of capital expenditure which did not produce an asset on the balance sheet. ECC Quarries (1975) [tab 55] and RTZ Oil & Gas v Ellis (1987) 61 TC 132 were also cited as authority for the view that the absence of a balance sheet asset was not determinative. Expenditure on a permanent advantage was also expenditure of a capital nature and reliance was placed on Anglo-Persian Oil Co Ltd v Dale (1932) 16 TC 253 and Van den Berghs (1935) where it was held that the cancellation of future rights under an agreement was of a capital nature. In any event, accountants were concerned to record transactions and not value; their concern was to record a true and fair view under the Companies Acts. Accountants only recognised an asset on the balance sheet if its existence and value could be recognised. But the fact that an asset could not be valued did not mean that it was not a capital asset. For example, expenditure on developing a brand name was expenditure on an asset which could be sold but accountants treated such expenditure as a deduction in the profit and loss account. The profit and loss

account was used for any transaction which did not appear elsewhere.

141. In considering the arguments of the parties we first consider the authorities cited to us in order to identify the principles which we should apply. In Atherton (1926) a company established a pension fund by a trust deed and so it was unlikely that the asset would have appeared on the company's balance sheet (although there appears to have been no evidence that it did not). However, that was an early decision and pre-dated the development of the acceptance of the correct rules of commercial accountancy. Nevertheless it is authority for the view that expenditure can be of a capital nature even if the asset acquired does not appear on the balance sheet. We have not found Anglo-Persian (1932) to be of help because that decision was that payments made to release a company from onerous contracts were of a revenue nature

142. In Van den Berghs (1935) a lump sum payment received in consideration of the taxpayer company consenting to certain profit-pooling agreements being terminated thirteen years in advance was held to relate to a capital asset of the company and was, therefore, a capital receipt. The cancelled agreements related to the whole structure of the company's profit-making apparatus and regulated the company's activities. Lord MacMillan said at page 432:

"In the present case it is not the largeness of the sum that is important but the nature of the asset that was surrendered. In my opinion that asset, the congeries of rights which the Appellants enjoyed under the agreements and which for a price they surrendered, was a capital asset."

143. Again, in that appeal there was no evidence of the accounting treatment and no evidence about whether the asset identified by Lord MacMillan appeared on the balance sheet. Nevertheless the case is authority for the view that an asset or advantage need not have a tangible existence and that the acquisition of goodwill could be expenditure of a capital nature.

144. In Kealy (1942) the shareholders of three companies set up a holding company which acquired the shares of the three companies in exchange for its own shares. One of the three companies claimed to deduct a part of the expenses of setting up the holding company. The High Court of Ireland held that the expenditure was of a capital nature; a radical and permanent change in the business organisation of the three companies had taken place. The transformation had altered the structure and destroyed the independence of the appellant company and something enduring had come into being which would affect the future working of all three companies. Again there was no

evidence of accountancy treatment and no evidence about the contents of the balance sheet.

145. In ECC Quarries (1975) the evidence was that the costs of the unsuccessful planning permission were charged as an outgoing in the profit and loss account and were not shown as assets in the balance sheet. Nevertheless Brightman J held that the expenditure was of a capital nature.

146. In Tucker (1979) the issue was whether a payment to a landlord of a lump sum to amend an onerous lease was of a capital or a revenue nature. Nothing was included in the balance sheet as representing the cost of the leasehold interest or of the payment. The evidence of the taxpayer company's auditor was that the payment should be charged in the profit and loss account but the evidence of the principal advisory accountant to the Board of Inland Revenue was that the payment represented expenditure on improving a fixed capital asset. The expenditure was held to have been incurred once and for all on the taxpayer company's lease which, though non-assignable, and hence having no balance sheet value, was valuable for its trade and hence a capital asset. The payment was, therefore, a payment of a capital nature. In the passage relied upon by Mr Gardiner at page 108f Lord Wilberforce referred to his opinion in IRC v Carron & Co (1968) 45 TC 18 where he had said that

"in some sense or other an asset of a capital nature, tangible or intangible, positive or negative, must be shown to be acquired".

147. Lord Wilberforce then explained that these words were directed to excluding cases where "no capital asset could be "seen" or identified". In Tucker he decided that the payment was a case of

"once and for all expenditure on a capital asset designed to make it more advantageous. It is true that the lease was non-assignable, so it had no balance sheet value before or after the modification.. But it was none the less an asset and a valuable one for the Appellant Company's trade, and, if an asset, was a capital asset."

148. Thus the identifiable asset test relied upon by the Halifax can include any asset of a capital nature tangible or intangible and whether or not it has a balance sheet value.

149. In RTZ Oil (1987) an oil company held a licence to exploit an oil-field and it was a condition of the licence that when the field was abandoned the wells should be capped and the equipment removed. The company hired a drilling rig and tankers and a condition of the hire was that the tankers had to be restored to their original condition. The company made provision for the close-down costs of the oil

field and for converting the tankers and claimed that such expenditure was of a revenue nature as they had not acquired an asset. The agreed accountancy evidence was that the accounts were correctly drawn up in accordance with the ordinary principles of commercial accountancy. Vinelott J held that that evidence did not bear on the issue as to whether the expenditure was of a capital or a revenue nature as the same provision would have to be made either way; it might be necessary to give a true and fair view of the profits earned by a trade in a given year to make an allowance for the depreciation of wasting asset on which capital has been expended but no such allowance should be made in assessing the taxable profits for the year. Relying on Tucker he held that the fact that the contract of hire was non-assignable and had no balance sheet value was irrelevant; the rig and the tankers were profit-making apparatus and the cost of re-conversion was capital expenditure.

150. In Wattie (1998) a lump sum received by a firm of chartered accountants as an inducement to enter into a lease at above market rent was held to be of a capital nature. It was made once and for all with a view to bringing into effect an asset or an advantage for the enduring benefit of the trade. At page 1170 Lord Nolan noted that a payment could be capital although not made for the acquisition or disposal of a particular asset.

151 In the light of the authorities cited to us we conclude that a payment may be of a capital nature even if not made for the acquisition or disposal of a particular asset. Also, for a payment to be capital it is not necessary to show the acquisition of an asset which appears on the balance sheet. If such an asset does appear then that would lead to the conclusion that the expenditure was of a capital nature but the lack of an asset on the balance sheet does not necessarily mean that the expenditure is of a revenue nature.

152. In the light of that conclusion we do not have to answer the next question raised by the arguments of the parties which asks if there was an asset on the balance sheet but as arguments were put to us we briefly express our views.

(4) - If so, was there a capital asset on the balance sheet?

153. For the Halifax it was argued that there was no asset. The expenditure on the conversion was not incurred on the creation, improvement or divestment of an asset of the Halifax. Expenditure could be of a revenue nature in the hands of the payer but of a capital nature in the hands of the payee. Before conversion the members owned assets being their rights as members of the Halifax Building Society; after conversion they owned equivalent assets being their rights as the members of Halifax plc company.

However, in this appeal the free shares in the public limited company given to the members of the building society were assets in the hands of the shareholders but a liability for the Halifax Building Society. There was no evidence that the expenditure had been made in order to protect or enhance goodwill.

154. For the Inland Revenue it was argued that, if it were necessary to identify an asset, that was either the equity shares in the public limited company issued to the members of the building society, or goodwill, or the Halifax brand name. Although on conversion the Halifax did not change its business methods the conversion did not leave the Halifax's fixed capital untouched. There was a big change with a new balance sheet and capital assets for the members as the shares were distributed to them. Alternatively, Mr Paterson had given evidence that where the assets of the business exceeded its liabilities the balance represented goodwill. Purchased goodwill that had been paid for was recognised on the balance sheet but not internally generated goodwill. However, that was only because the value of internally generated goodwill could not be ascertained; it was not that internally generated goodwill did not exist.

155 In considering the arguments of the parties we accept that, at first sight, it is tempting to say that the conversion costs paid for the acquisition of a public limited company with a capital value of £574M and that that was the asset acquired by the Halifax Building Society. However, the facts as found do not support that conclusion. The building society already had the £574M in its reserves which belonged to its members; all that the transfer did was to give the shares the characteristic of transferability which was a benefit in the hands of the shareholders but not in the hands of the Halifax Building Society. Further, we cannot agree that the conversion costs were paid for goodwill as the evidence does not support that conclusion. Again, there was no evidence that the payment was made to protect or enhance the Halifax brand name.

156 We have concluded above that a payment may be of a capital nature even if not made for the acquisition or disposal of a particular asset. Also, for a payment to be capital it is not necessary to show the acquisition of an asset which appears on the balance sheet. If such an asset does appear then that would lead to the conclusion that the expenditure was of a capital nature but the lack of an asset on the balance sheet does not necessarily mean that the expenditure is of a revenue nature. In this appeal no asset does appear on the balance sheet and so, in order to determine whether the conversion costs were of a capital or a revenue nature, we consider the principles established by the authorities. This leads us to the fifth question raised by the arguments of the parties.

(5) - What are the principles identified by the authorities?

157. It was argued for the Halifax that modern authority required a consideration of the effect of a transaction from a practical and business point of view and also required the application of common-sense rather than a strict application of any single legal principle. BP Australia v Commissioner of Taxes [1966] AC 224, Carron, Tucker and Wattie were also cited. From these authorities the argument was advanced that expenditure would be capital in nature if it secured an asset or advantage for the enduring benefit of the trade; or if an asset or advantage was acquired, improved or disposed of. However, a payment to remove an obstacle to successful trading was revenue in nature. The four principles to be applied where expenditure involved a change in the corporate structure of the taxpayer had been identified in Carron. They were: first, that a change in constitution was not automatically capital because it was necessary to consider why the structure had changed; to be capital there must be the acquisition or improvement of a capital asset or advantage; if the change led to the company carrying on its trade in a radically different way then that might be capital in nature; but a change which led the company to carry on its trade in a more efficient way was revenue in nature.

158. For the Inland Revenue it was agreed that there was no single determining principle and that it was necessary to approach the problem from the point of view of common-sense. Although there was no one test there were a number of pointers. Atherton (1926), Mitchell v BW Noble Ltd (1927) 11 TC 372, Mallett v Stavely Coal & Iron Co [1928] 2 KB 405 and Anglo-Persian Oil were cited. However, it was argued that the authorities should be approached with care and Regent Oil Ltd v Strick (1965) 43 TC 1 and BP Australia were referred to in this respect. Carron, where the previous charter had been antiquated and created immediate problems for the trade, was distinguished. In this appeal the BSA was recent and the Halifax Building Society had no immediate problems. In Carron there had been no new asset created whereas in this appeal an enduring advantage had been created. In Carron the company had not entered into new fields of trading whereas in this appeal the Halifax had obtained the potential for expansion. In Carron the corporate structure had been repaired but not changed and the problems of internal management had been eliminated but no new framework had been acquired; in this appeal the corporate structure had been replaced and considerably changed; also, value had been released to the members; the customer - member tension had been resolved; and the fixed capital had not been left untouched. There was a new legal entity and not just a change in the business organisation. The transfer agreement covered all the Halifax's business unlike the position in Mitchell v Noble and Carron. The change affected the whole of the profit-making apparatus and regulated the Halifax's activities. The

constitution was not an asset but a structure and the whole structure was changed. The constitution was a fixed framework which was renewed and not repaired. Kealy was cited as authority for the view that a new structure was a replacement and not a repair; also cited was Walker v The Joint Credit Card Co Ltd (1982) 55 TC 617

159. In considering the arguments of the parties we feel that we cannot do better than to start with the most recent authority and the words of Millett LJ in Vodafone v Shaw (1997) at page 739a where he said:

"Whether a payment is a capital or a revenue payment is a question of law. ... There is no single test or infallible criterion for distinguishing between capital and revenue payments. ... On the contrary, there are many factors which tend in one direction or the other, some of which are more relevant in some situations and some in others. Some factors are particularly relevant when the question arises on an acquisition and others are of particular relevance when a question arises on a disposal as it does in this case. Two matters are of particular importance: the nature of the payment and the nature of the advantage obtained by the payment. The fact that the payment is a lump sum payment is relevant but not determinative. In such a case as the present, where the payment is made in order to get rid of a liability, a useful starting point is to inquire into the nature of the liability which is brought to an end by the payment."

160. We therefore begin by identifying the nature of the payment and then go on to consider the nature of the advantage obtained by the payment. Initially we consider only the costs of conversion leaving to one side for the moment the statutory cash bonuses.

161. In identifying the nature of the payment we note straightaway that the payment at issue in this appeal is unusual because it is not a lump sum payment for the acquisition of an asset, or the release of a liability, but rather it is a payment of costs and expenses to a number of different suppliers. However, it was not disputed that, if an asset had been acquired, then the costs of acquiring the asset would be treated in the same way as the asset so that the costs of acquiring a capital asset would themselves be capital.

162. We then ask what advantage was obtained by the payment. Having considered all the evidence before us we have formed the view that in this appeal the advantage obtained by the payment was a change in the regulatory regime applicable to the Halifax. The building society wanted to escape from what were perceived to be the restrictions imposed by the BSA and the Building Societies Commission. The BSA provided only one possible route of escape and that was the transfer of the business of the

building society to a commercial company. The business of the Halifax was carried on in the same way, and by the same people, before and after the conversion. The advantage obtained by the payment was the ability to continue to trade in the same way but with fewer restrictions; an obstacle to successful trading and a recurring disadvantage had been removed.

163. Having identified the payment and the nature of the advantage obtained by the payment we now consider what principles to apply. It was agreed by the parties that there was no single determining principle and that it was necessary to approach the problem from the point of view of common-sense. Nevertheless, the authorities cited to us do contain pointers and so, before embarking on a common-sense approach, we have tried to identify the principles they contain. In doing this we note that the authorities cited by the Inland Revenue are much earlier than those relied on by the Halifax. We have considered the authorities in the order in which they were decided so that we can trace the development of judicial thinking over the years.

164. In Atherton (1926) a company which did not have a pension fund, and who found that it lost experienced members of staff so that the absence of a pension fund was injurious to its business, established a pension fund for its staff. The fund was constituted by trust deed which provided for annual contributions from both the company and the members and which also provided for an initial contribution from the company of £31,784.00 to form the nucleus of the fund. This sum was calculated actuarially to compensate for the fact that older members of the staff would not have paid sufficient contributions before they retired. The company paid the £31.784.00 out of current profits and the issue was whether it was deductible, the Inland Revenue arguing that it was of a capital nature. At page 213 Viscount Cave accepted that there would be cases where a single payment of a non-recurring nature would be deductible but he considered that where expenditure was made "with a view to bringing into existence an asset or advantage for the enduring benefit of a trade" that would be a good reason, in the absence of special circumstances leading to the opposite conclusion, for treating such expenditure as attributable to capital. The object and effect of the payment of the sum was to offer all employees a sure provision for their old age and so to obtain for the company the lasting advantage of being in a position throughout its business life to secure and retain the services of efficient staff.

165. If Atherton had been the only authority cited to us we would have seen the strength of the argument that the expenditure on the costs of conversion was made with a view to bringing into existence an advantage for the enduring benefit of the trade, namely, a new regulatory

regime. However, it is clear that Viscount Cave realised that there could be special circumstances leading to the opposite conclusion and so we consider whether such circumstances exist in this appeal.

166. Mitchell v Noble (1927) concerned the deductibility of a sum of £19,200.00 paid to a retiring director. Rather than dismiss a director the company negotiated a payment to be made to him in satisfaction of all claims against the company. The payment was to be made in five annual instalments. The Court of Appeal held that the payment was an admissible deduction in arriving at the profits of the company for tax purposes. At first instance Rowlatt J at page 415 distinguished the decision in Atherton and said that the payment was not made to buy an asset or to purchase an enduring advantage; it was more like a payment made to remove a recurring disadvantage. Although such a payment could be of a capital nature the payment to the director was a payment to get rid of a servant in the course of business and in the year in which the trouble came. Lord Hanworth MR at page 420 confirmed that view and said that the payment to the director was a payment made in the course of business dealing with a particular difficulty which arose in the course of the year and was made not in order to secure an actual asset to the company but to enable it to continue to carry on the same type and high quality of business unfettered and unimperilled by the presence of one who might have caused difficulty to the business. Sargent LJ at page 422 said that it was impossible to put the payment against the capital account of the company as it was made out of the profits of the company and did not add to or improve the equipment of, nor was it for the permanent benefit of, the company.

167. That decision has much in common with the present appeal. In this appeal the costs of conversion were paid to remove a recurring disadvantage, namely the restrictions under which the building society operated. They were paid in the course of business as they were deducted from the operating profit. They enabled the Halifax to carry on the same type and high quality of business unfettered by the restrictions of the BSA which caused difficulty to the business. The payments were not made in order to secure an actual asset as the new regulatory regime is not an asset owned by the Halifax; it is available to all companies incorporated in the same way as the Halifax. The payment did not add to or improve the equipment of the Appellant. However, in this appeal it could not be said that the difficulty against which the payment was made occurred in the course of one year; the difficulties with the regulatory regime under which the building society operated increased over time as a result of the changes in the environment in which the building society operated and to that extent the decision in Mitchell v Noble can be distinguished from the

facts in the present appeal.

168. In Hallstroms Proprietary Limited v The Federal Commissioner of Taxation (1946) 72 CIR 634 the appellant manufactured refrigerators on the basis that the patents held by a rival company were about to expire. The rival company applied for an extension to its patent and the appellant incurred costs opposing such extension. The High Court of Australia held that the expenses were of a revenue and not a capital nature. Latham CJ said at page 641:

"In my opinion the expenditure by the company was not made for the purpose of acquiring an asset or of adding to the profit-yielding subject which constituted the capital structure of the business but … was made not in order to secure an actual asset to the company but to enable them to continue, as they had in the past, to carry on the same business unfettered by a particular difficulty which had arisen in the course of the year."

169. This reasoning follows closely that in Mitchell v Noble upon which we have commented above. However, the decision in Hallstroms is also of interest because of the widely known words of Dixon J. He dissented from the majority decision and found that the expenditure was of a capital nature but said at page 648:

"What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process."

170. This principle was adopted in B P Australia (1966). In that appeal the appellant joined with three other companies to secure sites for the sale of its petrol and other products and paid a sum called a development allowance to service station proprietors who agreed to sell the appellant's products exclusively for a certain number of years. In finding that, on balance, the payments were of a revenue and not a capital nature the Privy Council approved the test set out by Dixon J in Hallstroms and held that the solution to the problem was not to be found in any rigid test or description but had to be derived from the whole set of circumstances some of which might point in one direction and some in the other and that the ultimate answer came from a common-sense appreciation of all the guiding features and that in borderline cases it depended on what the expenditure was calculated to effect from a practical and business point of view rather than the juristic classification.

171. In Carron (1968) a company incorporated by Royal Charter in 1773 found its constitution unsuited to modern trading conditions; in particular the company had a

restriction on borrowing and restrictions on the transfer of shares and voting rights. Its capital and voting structure required amendment, Accordingly a supplementary charter was applied for which would remove these restrictions; a number of the alterations had little to do with the company's trade. After the application had been made a shareholder took proceedings claiming that the procedure adopted was invalid. The company settled the action by buying out the shares of the shareholder and paying the costs. The House of Lords held that both the costs of the supplementary charter and the costs of buying out the shareholder were of a revenue nature. At page 48G the Lord President said:

" ... it appears to me that what was achieved by these payments was the removal of disabilities to the Company's trading operations which prejudiced its operations in its competition with its rivals. This was achieved without the acquisition of any tangible or intangible new asset and without the creation of a new branch of its trading activities. From a commercial and business point of view nothing in the nature of fixed capital was thereby obtained. The benefit was essentially of a revenue character because the Company became able to finance its day-to-day transactions, and more efficiently to carry on its day-to-day manufacture."

172. Those principles are almost on all fours with the facts which we have found in the present appeal. Here what was achieved by the costs of conversion was the removal of restrictions on the building society's trading operations which prejudiced its operations in the market-place in which it operated. The costs of conversion did not result in the acquisition of any tangible or intangible new asset and no new branch of trading activities was created. From a commercial and business point of view nothing in the nature of additional fixed capital was thereby obtained. The Halifax became as a result of the payments able more easily to carry on its day-to-day trading transactions.

173. In Walker (1982) a credit card company paid the sum of £75,000 to a rival company who thereupon undertook to cease trading in credit cards. The payment was described in the papers before the company's board as being for the protection of existing goodwill. Legal fees were also incurred. Walton J found that the payment was made for the benefits outlined in the paper before the board and that the money had been paid to obtain two particular permanent results one of which was the protection of the existing goodwill of the company. The payment involved the total closure of the business of the rival company and was of a capital nature.

174. A number of the authorities relied upon by the parties concerned leases of land. In Mallett (1928) a colliery company made payments to its lessor in consideration of

his accepting a surrender of leases and of releasing the company from its obligations under the leases. The payment was held to be of a capital nature. Lawrence LJ at page 422 held that the payments were sums paid for getting rid of a capital asset which had become burdensome to the company and that such a payment was on the same footing as a loss sustained on the disposal of fixed capital. However, in Anglo-Persian (1932) payments made to release a company from onerous contracts were held to be of a revenue nature. Rowlatt J distinguished Atherton on the ground that an enduring benefit was one which endured in the way fixed capital endured, not a benefit which endured in the sense that for a good number of years it relieved a company of a revenue payment. In Regent Oil (1965) the House of Lords held that lump sum payments by an oil company to retailers for exclusivity arrangements were of a capital nature because they took the form of a lease by the retailer of his premises to the oil company for a premium and a nominal rent with a lease back by the oil company to the retailer also at a nominal rent. The decision was based on the fact that premiums paid for leases were always regarded as of a capital nature and that the payments were made as the price of acquiring interests in land. In Tucker (1979) a lessee made a payment to the lessor to amend an onerous lease and in Wattie (1998) a lump sum was paid to a prospective tenant to induce it to enter into a lease at a rent above market rent. Both payments were held to be of a capital nature following Mallett and Strick. Because these authorities concern leases of land which are not in issue in the present appeal we have not found them to be of assistance. Also, in the present appeal the costs of conversion were not paid to get rid of a capital asset or an onerous contract; the argument was that they were paid to acquire a capital asset or enduring advantage.

175. Having considered the authorities cited to us we now stand back and look at the pointers which they have identified. First, the costs of the conversion did result in an advantage for the enduring benefit of the trade as mentioned in Atherton, namely the new regulatory regime. That would point to the conclusion that the payments were capital in nature. On the other hand one could also say that the payments were made to remove a recurring disadvantage as mentioned in Mitchell v Noble, namely the previous restrictive regime and that would point to the conclusion that the payments were revenue in nature. However, unlike the position in Mitchell v Noble the difficulties of the Halifax Building Society did not occur in the course of one year but over a longer period which might point to the payments being of a capital nature. Again, the expenditure was not made for the purpose of acquiring an asset, or of adding to the profit-yielding subject which constituted the capital structure of the business, but for the purpose of enabling the Halifax to continue to carry on the same business unfettered by a particular difficulty as in Hallstroms, which would point to

the payments being of a revenue nature. Again, however, unlike the position in Hallstroms, the particular difficulty did not arise in the course of a year which would point to the conclusion that the payments were capital in nature. Another pointer is that the principles of merger accounting were used on the transfer of the business on the basis that the transfer was an internal arrangement involving no change to the overall ownership of the business and that would point to the conclusion that the conversion costs were of a revenue nature.

176. Thus, some of the factors in the present appeal tend in the direction of a conclusion that the payments were of a capital nature whereas others tend in the direction of a conclusion that the payments were of a revenue nature. At this stage our view is that the relevant factors on balance support the view that the payments were of a revenue nature. However, following BP Australia, we conclude that the ultimate answer will come from an appreciation of all the guiding features and that, as this is a borderline case, the answer will depend on what the expenditure was calculated to effect from a practical and business point of view. However, before considering that question we consider the relevance of the purpose of the expenditure.

(6) - What is the relevance of the purpose of the expenditure?

177. For the Halifax it was argued that, in order to determine the practical and business effect, it was necessary to have regard to the purpose of the transaction. It was accepted that the purpose the taxpayer had in mind was not determinative of the question but it was extremely relevant and reliance was placed on Lawson v Johnson Matthey Plc (1992) 65 TC 39 at p 79.

178. For the Inland Revenue it was argued that, in ascertaining the nature of the payment, the question was not whether the expenditure was incurred for the purposes of the trade but whether it was categorised as of a capital nature and its effect. Johnson Mathey was cited; this rejected the purposive test as the correct test. Lord Goff had made it clear that subjective intention was not relevant. In this appeal the effect of the expenditure was nothing to do with the trade but had everything to do with the creation of a new capital structure. Tucker was also relevant.

179. In Tucker (1979) at page 113E Lord Edmund-Davies made it clear that it was undesirable to determine the nature of a payment by the motive or object of the payer. The correct question was whether the payment brought some asset or advantage into existence and whether it was an enduring asset or advantage, enduring in the same way that fixed capital endures. In Johnson Matthey (1992) at page 79 Lord Goff stated that the payment did not become

a revenue payment simply because it was paid for the purpose of preventing the trade from collapse. The question was whether the payment should be characterised as a payment of a capital nature and that characterisation did not depend upon the motive or purpose of the taxpayer.

180. We conclude that the motive or intention of the Halifax is not relevant in determining the nature of the conversion costs. What we have to ask is whether the conversion costs brought into existence some asset or advantage which endures in the same way as fixed capital endures.

181. In the light of that conclusion we now turn to consider the practical and business effect of the transaction.

(7) - What was the expenditure calculated to effect from a practical and business point of view?

182. It was argued for the Halifax that the substance of the transaction was that the Halifax wanted to move from one regulatory regime to another and, under the BSA, that was not possible without the transfer to a commercial company. Also, the Taxes Act taxed the profits and gains of a trade and what required to be determined was whether the expenditure was incurred for the purposes of the trade.

183. For the Inland Revenue it was argued that, in categorising the transaction for tax purposes, it was necessary to recognise that the conversion process resulted in the transfer of all the assets and liabilities of the Halifax Building Society to a new legal entity followed by the dissolution of the building society. Before conversion the members of the building society were not entitled to transfer their shares and in practice did not receive distributions of profit. After conversion the shareholders could dispose of their shares for market value (which would reflect the value of all the assets including goodwill). Thus there had been a release of value to the members. The change of entity was similar to a re-organisation and reconstruction. The expenditure had been designed to achieve a new governing structure, release of value to the shareholders, and regulatory changes. All these were enduring matters of permanent importance and produced capital assets in the hands of the members.

184. Having considered all the evidence before us we conclude that, from a practical and business point of view, the expenditure on the conversion costs was calculated to effect a transfer from a restrictive regulatory regime to a more flexible regulatory regime. This was undertaken for the purposes of the trade of the Halifax. In particular, the building society wanted to borrow above the wholesale funding limits and could not do so. The only remedy available to the building society under the BSA was the

transfer of its business to a commercial company. The Halifax Building Society did not necessarily want to be a public limited company but that was the only way it could escape from the restrictive regulatory regime. The business of the Halifax was carried on in the same way, and by the same people, before and after the conversion.

185. The change to the only different regulatory regime permitted by the BSA had, as a necessary consequence, an effect on the members of the building society. Before the conversion the members were members of the building society. Their shares were not transferable and so the members would only receive value for their shares on a dissolution. It is possible for a building society to make distributions of profits to its members but we were told that in practice, at least at the time of the events subject to this appeal, this was rarely if ever done. The profits were accumulated from year to year and appeared in the balance sheet as reserves. The inclusion of the amount of the reserves as a liability in the balance sheet no doubt reflected the fact that the reserves represented funds owing to the members of the building society on a distribution or a dissolution. On conversion a part of the reserves was spent in the purchase of shares in the public limited company and those shares were given to the members. This made no difference to the Halifax whose liabilities to its members remained substantially the same as before conversion. No new liability was created. The share capital, share premium account and profit and loss item were no doubt included on the consolidated balance sheet under the sub-heading of "equity shareholders' funds" to indicate that they were all amounts owed to the shareholders on a distribution or dissolution.

186. This treatment indicates that before the conversion the reserves were owed to the members of the building society and that after the conversion the same amount with the addition of the profit for the current year (the totality now called profit and loss account) was owed by the successor company to the shareholders. Thus a comparison of the two balance sheets indicates that on conversion there was a re-ordering of the way in which the entity's liabilities were arranged. It does not appear that any new liability was created because the difference in the total figures in the two accounts appears to be explained by the profit for the intervening year. However, the members could now transfer their shares at market value. It was argued for the Inland Revenue that these were capital assets in the hands of the members and that may or may not be true. If the shares were held by dealers in shares then they would be trading stock. But the fact remains that the shares were not capital assets in the hands of the Halifax.

187. Having heard the evidence we conclude that it was not the practical and business effect of the conversion to

release value to members. As far as the directors of the Halifax were concerned the issue of free shares was just one of the many things that was a consequence of the conversion. As we have said above, if the directors could have achieved their purpose of escaping from the restrictive regulatory regime without the creation of a public limited company (which necessarily meant the issue of shares) they would have done so. There was no pressure from the members for release of value at that time.

188. We conclude that from a practical and business point of view the expenditure was calculated to effect a change of the regulatory regime applicable to the Halifax so that the Halifax could more easily carry on its trade. The Appellant wished to remove an obstacle to its successful trading. That would point to the conclusion that the expenditure was of a revenue nature following Mitchell v Noble, Hallstroms and BP Australia. The new regulatory regime is not an asset now possessed by the Appellant because it is available to all companies incorporated in the same way as the Appellant. The business was carried on in the same way, and by the same people, before and after the conversion. The advantage obtained by the payment of the conversion costs was not a new asset but the ability to continue to trade in the same way but with fewer restrictions.

189. Having considered the practical and business effect of the transaction we conclude that the conversion costs were of a revenue nature.

8. - Should the costs of the abortive treasury bank and/or Halifax Single Company PEP and/or Halifax Share Dealing be dealt with differently?

190. For the Halifax it was argued that neither the costs of the abortive treasury bank nor of Halifax Single Company PEP nor the costs of Halifax Share Dealing were capital in nature. No capital assets had been created as a result of any of these heads of expenditure.

191. For the Inland Revenue it was argued that the costs of the treasury bank, although abortive, were governed by the ECC Quarries case and Kealy and so the set-up costs were not revenue but capital in nature. The establishment of Halifax single Company PEP was to be treated like computer expenditure and was capital in nature. Halifax Share Dealing was the same as Halifax Single Company PEP and was a capital structure.

192. These arguments were raised at a very late stage in the appeal and were not fully developed. As far as the abortive treasury bank is concerned, we are not convinced that it should be dealt with differently from the conversion costs generally. It was only considered as part of the transfer of the business of the building society to the public

limited company and, in any event, it was not proceeded with. No asset was created as a result of this expenditure and no enduring advantage was obtained. Both Halifax Single Company PEP and Halifax Share Dealing were established and, it appears, remain in being. However, the evidence before us on these matters was not sufficiently specific as to enable us to conclude that they should be dealt with differently from the conversion costs generally

193. We conclude, therefore, that these three matters should be dealt with in the same way as the conversion costs generally.

(9) - Should the statutory cash bonuses be treated differently?

194. So far we have considered only the costs of conversion in relation to the capital or revenue expenditure issue. We now turn to consider the statutory cash bonuses.

195. For the Appellant it was argued that the statutory cash bonuses were an inevitable cost of conversion and following Carron the cost was revenue expenditure. Section 100(4) of the BSA provided that the bonuses were paid as compensation for the loss of the right to vote on the conversion and so they were an inevitable cost of conversion and therefore deductible. Alternatively, as Mr Carne would have accepted that the bonuses could have been deducted in the profit and loss account if the recipients had not been entitled to participate on a dissolution, and as some would and some would not, then at least those that would not should be allowable.

196. For the Inland Revenue it was argued that the statutory cash bonuses were paid to reflect the shares in the reserves which the recipients did not receive by means of issued shares. It was accepted that the BSA said that they were compensation for members who lost their vote but it was argued that the bonuses reflected the loss of membership status for non-voting members losing their advantages. Both accountants had accepted that the bonuses were properly treated as deductions from reserves and not from operating profits. In any event the relief was denied by section 74(1)(f).

197. In considering the arguments of the parties we begin with section 100 of the BSA. That provides that the statutory cash bonuses are mandatory; that they are to be paid to members not entitled to vote on the transfer; and that the amount to be paid is the proportion of the building society's reserves which the member's shares bears to the total shares. Although the payment is linked to the lack of an entitlement to vote the amount is equivalent to the proportion of the members' funds (reserves) to which the recipient is entitled. That leads to the conclusion that the bonuses were payments of capital. The view that the

statutory cash bonuses were capital is confirmed by the fact that the recipients were not liable to income tax but to capital gains tax.

198. The accountancy evidence was that the statutory cash bonuses had been correctly shown as a deduction from the profit and loss reserves in the balance sheet. In the consolidated balance sheet there was a sub-heading of "equity shareholders' funds". This comprised the three items of share capital, share premium account, and profit and loss. The profit and loss item was derived from the balance brought forward from the previous year with the addition of profit for the current year but with the deduction of the amount of the statutory cash bonuses and the amount of the share capitalisation. In our view the fact that the statutory cash bonuses were treated in the same way as the money paid for the share capitalisation indicates that the bonuses are of the same nature as the money paid for the share capitalisation. It was accepted that the money paid for the share capitalisation was capital in nature and so it follows that the accountancy treatment indicates that the statutory cash bonuses were capital in nature. Thus these sums are not deductions in computing the profits of the trade and for that reason would not be allowable deductions under section 74.

199. The two accountancy witnesses agreed that if the bonuses were not paid in recognition of membership rights then they may have been correctly deducted in computing operating profit. However, from our reading of section 100 we conclude that the bonuses were paid in recognition of membership rights as the amounts were directly related to the members' shares in the building society's reserves.

200. The Halifax raised an alternative point which was that those members who did not have a right to participate on a winding up should be treated differently; the argument was that they were not being paid anything in recognition of their membership rights; in this appeal that would include members with balances of less than £100 and minors with accounts for less than two years. However, such members are not treated differently under section 100 and so we do not accept that their entitlement on a winding up should alter the nature of the bonuses.

201 However, even if the Halifax were right, so that such sums were correctly deducted from operating profit under the correct principles of commercial accountancy, it is still necessary to go on and ask whether the bonuses are specifically disallowed under section 74(1)(f).

202 We are of the view that the statutory cash bonuses represent capital withdrawn from the trade within the meaning of section 74(1)(f). Whereas the distribution of shares in the public limited company to the members of the building society did not give rise to any new liability for the

Halifax, but merely made the shares transferable by their recipients, the payment of the statutory cash bonuses by the Halifax did give rise to a new liability and so in our view did represent capital withdrawn from the trade. Also, so far as this is relevant, the distributions were not of an income nature in the recipients' hands as the latter were liable to capital gains tax on their receipt and would have received interest on their deposits separately. The distributions were of a capital nature.

203 The Halifax argued that the statutory cash bonuses were on the same footing as the payments made to buy out the dissenting shareholders in Carron. However, in Carron it does not appear that this point was fully argued. In the First Division of the Court of Session it was agreed by the parties that both sums should be treated together on the footing that the legal expenses of dealing with the dissenting shareholders were intimately connected with the granting of the charter. (See the judgment of Lord Guest at page 70A).

204. In the House of Lords Lord Reid said at page 66H:

"Although the cost of reaching a settlement with the dissident shareholders was so very much greater than the cost of obtaining the new charter, I need not consider the circumstances in which this settlement was made, because it has been admitted by the Crown that, if the Respondents are entitled to deduction of the cost of obtaining the charter, they are also entitled to deduct the cost of making the settlement."

205. Lord Reid continued at page 67H:

"The case for charging it [the expenditure] to capital might appear to be strengthened by the magnitude of the sums involved, but again I do not think it would be right to take into account the sums paid to the dissident shareholders in deciding what should be done with the cost of obtaining the new charter. If this, taken by itself, is a proper charge against income, it cannot become chargeable to capital because it was first necessary to buy off these shareholders. And if the smaller sum is chargeable against income it is not suggested that the larger sum could be chargeable against capital."

206. There was no argument in Carron that the payment by the company for the shares purchased from the dissenting shareholders was capital withdrawn from the trade. In the present appeal, however, that argument was put to us and for the reasons we have given we find it to be convincing.

207 Our conclusion on the ninth question is that the statutory cash bonuses are capital in nature.

Conclusions on the capital or revenue expenditure issue

208. Our conclusions on the capital or revenue expenditure issue are:-

(1) that the costs of conversion are deductible in computing the amount of profits to be charged to tax; but

(2) that the statutory cash bonuses are not so deductible.

Conclusion

209. We accordingly allow the appeal in part. All the disputed expenditure, other than that incurred in paying the statutory cash bonuses, is allowable as a deduction in computing the Halifax's profits for tax purposes.

STEPHEN OLIVER QC

NUALA BRICE

SPECIAL COMMISSIONERS

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