

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 partly for purposes of subsidiaries' trades - No - Whether incurred partly to release value to members - No - Whether incurred partly to resolve proprietary interests of members - No - Income and Corporation Taxes Act 1988 s.74(1)(a)

DEDUCTION IN COMPUTING PROFITS - Capital or revenue expenditure - Conversion of building society to listed bank - Whether payments for advisory and other services capital expenditure - No - Whether statutory cash bonuses capital expenditure - Yes - Appeal allowed in part - Income and Corporation Taxes Act 1988 s 74(1)(f)

THE SPECIAL COMMISSIONERS

ALLIANCE AND LEICESTER PLC Appellant

- and -

K HAMER

(HM INSPECTOR OF TAXES) Respondent

Special Commissioners: STEPHEN OLIVER QC DR A N BRICE

Sitting in public in London on 6-9, 14 and 29-31 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 21 April 1997 the Alliance & Leicester plc succeeded to the property, rights and liabilities of the Alliance & Leicester Building Society. The Alliance & Leicester plc was specially formed for the purposes of conversion which took place under the provisions of section 97 of Building Societies Act 1986 ("BSA"), from building society to bank.

2. The terms "Alliance & Leicester Building Society" and "Alliance & Leicester plc" are used where we refer specifically to the activities, rights and liabilities etc of those two entities. Otherwise we use the term "the Alliance & Leicester" which refers to the Alliance & Leicester Building Society until 21 April 1997 and to the Alliance & Leicester plc from then on.

3. The costs of conversion, which included "statutory cash bonuses" of some £17.9 million, amounted to £64.5 million. Alliance & Leicester have deducted this amount in computing profits for tax purposes for the periods in which the expenditure was incurred. The Inland Revenue have disallowed the full amount as a deduction on the grounds that it is capital expenditure and that it was not incurred wholly and exclusively for the purposes of Alliance & Leicester's trade. Alliance & Leicester has appealed and we have been asked to resolve the issues as matters of principle leaving amounts to be agreed.

Evidence

4. Documentary evidence included -

Accounts of Alliance & Leicester Building Society and Alliance & Leicester 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 15 October 1996

Stock Exchange Listing Particulars

Strategic Plan, 1996-1997 provided for Bank of England

Building Societies Commission Guidance Notes

Board minutes, Board papers and memoranda

Press releases

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

relations advisers and stockbrokers etc

Internal conversion documents

Communications with members and customers etc

Correspondence with Inland Revenue

Sample invoices etc

5. This was the last in succession of four appeals relating to the costs of conversion. The other appeals were those of -

Halifax plc v Davidson (2000) SpC 239

Northern Rock plc v Thorpe (2000) SpC 240

Woolwich plc v Davidson (2000) SpC 241

6. Evidence relating to the Alliance & Leicester appeal alone was given by -

(i) Richard Pym, group finance director of the Alliance & Leicester at the relevant time

(ii) Susan Reeves, project manager at the Alliance & Leicester

The witnesses whose evidence applied to all four appeals (and whose qualifications are given in the Halifax decision) were -

(i) Ronald McNeill Paterson FCA

(ii) Terence Mathews

(iii) Christopher Knight

(iv) T C Carne FCA

References to oral evidence are given by citing the day and the page, e.g. 9/24.

7. The introduction to the issue set out in the Halifax decision is applicable to the present decision.

The disputed costs

8. The disputed costs were incurred during the twelve month period to 31 December 1996, to 20 April 1997 and to 31 December 1997. These related to the steps to implement the conversion and to the payment of the statutory cash bonuses. The events that triggered the incurring of the costs was confirmation, on 30 January

1996, of the Board's decision to convert. The costs, which are similar in nature to those incurred by the Halifax (and are described in more detail in the Halifax) were -

- (i) Corporate finance (J P Morgan, bankers)
- (ii) Legal, regulatory and treasury advice (Linklaters & Paines, lawyers, and Alan & Overy, lawyers)
- (iii) Accountancy and auditing and financial reports (KPMG, accountants)
- (iv) Broking (Cazenove & Co).

Of the total expenditure of £64.5 million, the following are the principal ingredients:

Staff and staff related £ 2.4 million

Agency £ 4.8 million

Literature/stationery/printing £ 5.1 million

Postage and mailing £ 5.9 million

Communications and advertising £ 2.2 million

Legal and advisory £15.6 million

Share registration/distribution £ 3.3 million

Regulatory and treasury £ 3.3 million

Statutory cash bonuses £17.9 million

Background facts

9. Alliance & Leicester Building Society was founded in 1853. In 1974 it merged with the Leicester Temperance General Permanent Building Society and in 1995 merged with the Alliance Building Society to form the Alliance & Leicester Building Society.

10. Until conversion it was run in accordance with mutual principles, owned by its members who were the depositors who held ordinary share accounts and borrowers who held mortgage accounts. In common with other building societies it had moved beyond the traditional activity of raising funds from investing members and lending them to borrowing members and was offering to customers products and services that did not confer membership of the society, e.g. unsecured personal loans. The consequence was that the interests of the members of the Alliance and Leicester Building Society had ceased to be the

same as the interests of its customers.

11. Prior to conversion the Alliance & Leicester was the fourth largest building society in the United Kingdom. It had over 4 million savings and investment accounts, over 520,000 mortgages with total mortgage balances of £16.9 billion. It had 1.2 million current account holders and savings and current account balances amounted to £16.4 billion. In 1996 its revenue surplus was £201 million on total assets of £22.3 billion.

Description of business of Alliance & Leicester group

12. Operating with the objective of being a "first rank provider of personal financial services supported by a unique commercial bank" (see annual report and accounts 1996), the Alliance & Leicester Building Society and its subsidiaries were organized into three business units. These were mortgage lending, investments, and personal banking.

13. The activities of the group that were carried on by Alliance & Leicester Building Society itself were as follows -

- The "mortgage lending" business which offered fixed and variable rate mortgage products, including those repayable by pensions, PEPs and endowments, to residential purchasers. Secured residential lending of Alliance & Leicester Building Society represented over 73% of total assets of this business. Mortgage lending was regarded by the Alliance & Leicester Building Society as its core business, its assets representing 93% of total group assets.
- The "Investments" business offered a range of savings products, including instant access and notice accounts, TESSAs, PEPs and fixed rate products. Retail savings of the investment business represented over 71% of its total liabilities.
- The "Personal Banking" business offered current accounts, overdraft facilities, telephone banking and credit cards. This represented 9% of its retail savings.

The "treasury" function was carried out by Alliance & Leicester Building Society itself. When it lent funds to other companies in the Alliance & Leicester group it charged a market rate of interest. Apart from managing liquidity, the "treasury" activity raised funds to support the mortgage and other lending activities of the core business.

Activities of the main subsidiaries

14. At the relevant time there were nine subsidiary companies in the Alliance & Leicester group. The main ones were as follows -

(1) Girobank plc offered a range of services to business and local authority customers including cash and cheque handling, bill payment and treasury services. Girobank is one of the market leaders in money movements for business. In April 1994 its private customer base was transferred to Alliance & Leicester's own private banking division; this added 1½ million customers to the latter's customer base. At 31 December 1996 it held 11.69% of group net assets. Alliance & Leicester Building Society held 81.76% in value of group net assets and 92.4% of reserves at that time; and it contributed 18.08% to group pre-tax profits.

(2) Alliance & Leicester Personal Finance Ltd made unsecured loans to customers. Its net assets were 2.08% of group net assets at 31 December 1996 and it contributed 15.55% to group pre-tax profits.

(3) Alliance & Leicester Estate Agents Holdings Ltd represented a deficit of 0.61% of group net assets and contributed 0.6% to group pre-tax profits.

(4) Alliance & Leicester Life Assurance Co Ltd and Alliance & Leicester Unit Trust Managers Ltd were launched in 1996 and generated fee income. For 1997, their first full year of operation, £2.3 million in fees were earned from "Life Assurance" and £2.9 million from "Unit Trusts". The Life Assurance and Unit Trust activities were, Mr Pym explained, "used in support of the mortgage business essentially to support a mortgage sale" (17/9).

(5) Alliance & Leicester Estates Ltd, a property development and management company, held 0.06% of net assets and contributed 0.63% to group pre-tax profits.

(6) Sovereign Finance Plc and Sovereign Holdings Plc, a leasing company, was acquired by Girobank on 13 November 1996.

The trading activities of many of the subsidiaries had been retained within those subsidiaries for regulatory reasons applicable to either the building society itself or to the subsidiary in question. The effect of the statutory requirement that the building society should have unlimited liability for the debts of its subsidiary had, Mr Pym said in his witness statement, led Alliance & Leicester to regard subsidiaries as being, for most purposes, integral parts of the divisions to which they related.

Supervision

15. The Alliance & Leicester was regulated by the Building

Societies Commission until 21 April 1997. Prior to conversion it was governed by a 12-strong board of directors made up of the chairman, four executive directors and seven non-executives.

Regulatory position under the BSA

16. This is summarized in paragraphs 21 and 22 of the Halifax decision. It is not in dispute that the Alliance & Leicester was affected by the same regulatory constraints as were regarded by the Halifax board as restricting their opportunities to react to competition and develop new projects and new products.

Growth of competition

17. Throughout the 1970s building societies had operated in exceptionally benign trading conditions. To a large extent, this had been due to the artificial balance sheet ratios imposed on banks until about 1980 which had made it difficult for them to compete with building societies either in the provision of mortgage lending or of short term retail savings. This competitive advantage had been reinforced by tax subsidies for retail house purchase and of certain political factors such as the "right-to-buy" legislation. In the period proceeding conversion, however, these trading advantages had been heavily eroded. The housing slump of the late 1980s and early 1990s had given rise to widespread fears of excess capacity in the mortgage industry and had exposed all building societies to greater competition. Moreover, the public had become more knowledgeable and sophisticated in relation to retail savings products.

Events leading to conversion

18. The issue of conversion had been first considered in 1987 and again in 1988 with a view to putting a conversion proposal to members in November 1988; however it was subsequently decided to remain as a mutual body. The matter was formally considered again in 1995 as part of a wider strategic review of the business. The minutes of these meetings and reviews will be referred to where relevant when we deal with the issues.

19. Between May and August 1995 the board considered the options of (a) converting having first merged with another building society and of (b) converting alone. They decided that (b), conversion alone, was preferable and on 17 October 1995 the chairman distributed a board paper entitled "The Way Forward". This reviewed the pros and cons of conversion. This paper formed the basis of discussion at a board meeting on 26 October 1995 at which it emerged that there was unanimous consensus in favour of progressing the conversion option. It was accordingly resolved to proceed with all haste towards conversion

under a steering committee of six, of which Mr Pym, who gave evidence, was one. It was also agreed that the then current discussions with a view to a possible merger with the Woolwich Building Society should be terminated; it was thought that continuing discussions would divert attention from their main task. Although the decision to convert had been taken comparatively late in relation to other building societies, the Alliance & Leicester implemented the process faster than others, making the announcement in January 1996 and reaching their vesting date in April 1997.

20. The group chief executive, Peter White, produced a paper on 7 December 1995 headed "Rationale". This starts with the comment that there is "no one overwhelming reason behind the decision to convert, rather it is a summation of various considerations, outlined in this paper". It goes on to identify the following as components of the reason behind the decision to convert -

- Clarifying tensions existing in the relationship between a building society and its members by transferring ownership rights in the society to shares in the plc.
- Access to additional capital sources to support business expansion and to fund acquisitions (commenting that Alliance & Leicester has "no plans, at present, to move into new areas other than personal lines, general insurance and a slightly broader treasury activity").
- The ability to raise a greater proportion of funds from wholesale, rather than retail, sources.
- Credit rating agencies might perceive a deterioration in the credit worthiness of all building societies following the departure of the Halifax Building Society from the sector.
- Conversion should enable the Alliance & Leicester group to maintain an independent entity with a commitment to a successful independent future.

Appointment of advisers

21. The following were appointed for purposes of the conversion procedures -

- (i) "Focus" (corporate and financial public relations).
- (ii) Morgan Guaranty Trust Company of New York (J P Morgan) (corporate finance)
- (iii) KPMG (accounting and auditing). Among their functions were acting as scrutineers, producing reports for the Bank

of England and the information required for the Transfer Document.

(iv) Cazenove & Co (broking)

(v) Allen & Overy (legal) to provide advice on the impact of conversion on treasury activities

Internal organization of conversion process

22. A steering committee was set up as a sub-committee of the Board to take over all responsibility. An Executive Steering Group was established to oversee the project and set and oversee budgets. The conversion process was then broken down into seven separate projects.

The formal steps in the conversion

23. The conversion was achieved under section 97 BSA by five main steps -

(i) Alliance & Leicester Building Society subscribed cash for shares in Alliance & Leicester plc, a newly formed company which was to assume and conduct the society's business in its place;

(ii) Alliance & Leicester Building Society entered into a Transfer Agreement of 15 October 1996 with Alliance & Leicester plc under section 97 BSA conditional on member and regulatory approval;

(iii) On vesting day Alliance & Leicester Building Society transferred its business to Alliance & Leicester plc;

(iv) Alliance & Leicester Building Society distributed its shares in Alliance & Leicester plc to its members and

(v) Alliance & Leicester Building Society was dissolved.

Under the terms of the Transfer Agreement the business was transferred to, and vested in Alliance & Leicester plc "as if in all respects the (Society) and the (Company) were the same person in law".

Post conversion events

24. As a result of instructions given prior to the vesting day, some 27% of the new shareholders sold their shares on flotation at the weighted average price of 533p.

25. On 17 May 1997, in accordance with section 100(2)(b) BSA, statutory cash bonuses of some £17.9 million were paid to members not entitled to free shares. On 21 April 1997 the Bank of England formally authorized Alliance & Leicester plc under the Banking Act 1987. With effect from

conversion Alliance & Leicester plc was regulated by the Bank of England and subject to the Bank's capital adequacy, liquidity and reporting requirement.

26. The Inland Revenue challenged the deductibility of the conversion expenditure on the grounds that it was not laid out wholly and exclusively for the purposes of the trade of Alliance & Leicester (see Income and Corporation Taxes Act 1988 s 74(1)(a)) and that it was of a capital nature and so was non-deductible either as a matter of principle or by operation of section 74(1)(f). The reasoning behind the contentions of the Inland Revenue is summarized in our review of the particular issues.

The "wholly and exclusively issue"

Issue 1: Were the conversion costs incurred for the purposes of the activities of the subsidiaries?

27. The Inland Revenue's case for contending that the expenditure was not incurred wholly and exclusively for the purposes of the trade of Alliance & Leicester focussed on two factors that either were or may have been taken into account in the decision to convert. The first of these was the flexibility, gained from freedom from the BSA constraints, to go for the "optimal mix by selecting between wholesale and retail debt so as to achieve the lowest funding costs": the quotation is from Appendix 1 to papers considered at the board meeting of 25 January 1996 (the meeting at which the board agreed to accept the steering committee's recommendation to convert to plc status). Also relevant was the "Class 3 commercial asset limitation" of 15% imposed by the BSA in relation to group debtors. (This was the rule that dictated the composition of the assets of the society in question other than fixed assets and liquid assets. This rule required that at least 75% of such assets had to comprise mortgage loans secured on residential property (Class 1 assets) and no more than 15% by the comprised assets other than loans secured on property (Class 3 assets comprising overdrafts, credit card loans, investments in subsidiaries and diversified assets).) Those advantages, it was argued for the Inland Revenue, were sought both for Alliance & Leicester and for its subsidiaries, particularly Alliance & Leicester Personal Finance Ltd and Girobank, which between them contributed over one-third of group net profits.

28. Mr Pym had been questioned in cross-examination about the implications of the group's wholesale borrowings reaching the limits imposed under the BSA in those situations where regulations required the aggregation of group assets and liabilities for "nature limit" purposes. It was put to him (17/26) that in those circumstances the relevant subsidiary, e.g. Alliance & Leicester Personal Finance or Girobank, could not borrow more money because it would put the group beyond its limit. He

accepted this, qualifying his answer with the observation that "the impact of course is purely on the society". He went on to express the view that the directors of a subsidiary would be acting "ultra vires" if they sought to borrow amounts that would put the group as a whole in breach of its nature limits. (We are not convinced that this is the true position in law; the ultra vires complaint is more likely to attach to the building society rather than its subsidiaries.) Mr Pym agreed that the Class 3 commercial asset limit applied "across the subsidiaries" but he said that he could not remember ever having been concerned about that limit and he could not recollect any discussion where the Board had been concerned with it (17/28).

29. We do not see removal of the wholesale borrowing limit as a purpose designed to benefit the activities of Alliance & Leicester Personal Finance and Girobank. In the first place it was a theoretical benefit. There is no evidence that the business of either subsidiary caused concern to the board of Alliance & Leicester Building Society that the wholesale borrowing limits of the group as a whole would be breached. Indeed Mr Pym (17/30) said that the real concern had not been with Girobank's borrowings but with the mismatch "between the residential mortgages and the growth in retail deposit that one would normally in a building society seek to match". The real and only purpose in seeking to remove the wholesale limits, as we see it, was the core trading operation of the Alliance & Leicester Building Society itself. The same goes for the Class 3 commercial assets limit; that, as we have noted, had been of no concern to Mr Pym or indeed to those with whom he had held discussions so far as it affected the building society's activities, and there is not a hint in any of the board papers that that limit had been a concern in relation to the subsidiaries' activities. Accordingly we accept Mr Pym's evidence on these points.

30. Of greater concern to Mr Pym than the Class 3 commercial asset limit had been a Bank of England requirement that restricted the amount of funding that Girobank could provide direct to the Alliance & Leicester. That requirement obliged Girobank to spread its loans (representing, for example, funds obtained from depositors) and a limit was imposed on each loan. To lend all its funds in hand to Alliance & Leicester Building Society would breach the limit. Girobank had to lend to other banks and building societies and those banks and building societies had then to onlend to Alliance & Leicester charging a mark-up on the way. The effect of conversion, according to Mr Pym (17/52), was to enable Girobank to make greater loans to Alliance & Leicester, thereby benefiting Alliance & Leicester which in consequence paid a lower rate of interest. Also, the Bank of England limit imposed on Girobank's loans to, for example, the Halifax would not be used up by loans destined for onlending by

the Halifax to Alliance & Leicester.

31. Further, in the context of wholesale borrowing limits and Class 3 commercial asset limits, there was no evidence that benefiting Alliance & Leicester Personal Finance' unsecured lending business was a purpose for securing release from these constraints following conversion.

32. Overall, it seems to us, the board's purpose in seeking to obtain release from the BSA constraints was to secure freedom from the nature limits and the Class 3 commercial loan limits, thereby enabling Alliance & Leicester to carry on business free from the need to obtain approval whenever it embarked on a new project (17/84). We have reviewed the board minutes and the Transfer Document and can find nothing that in any way suggests that the board's purpose or one of its purposes was to benefit the trade of either Girobank or Alliance & Leicester Personal Finance, or indeed of any of the other subsidiaries. (In the last connection we mentioned that the other subsidiaries were very small in relation to the rest of the group and as regards the "Life Assurance", the Unit Trust" and the "Estate Agency" subsidiaries, they were supportive of Alliance & Leicester building society's core business.)

33. Finally on this topic we have looked at the circumstances and the evidence as a whole to determine whether we should conclude that the consequences of benefiting Girobank and Alliance & Leicester Personal Finance were 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": see Millett LJ 's fourth proposition set out in the decision of the Court of Appeal in Vodafone Cellular Ltd v Shaw [1997] STC 734 at 742 (see paragraph 45 of the Halifax decision). The evidence demonstrates the contrary. The real and predominant purpose of the expenditure was to benefit the core business then carried on by Alliance & Leicester Building Society. The evidence that we have reviewed shows that there was no requirement to benefit the trades of the subsidiaries and the board cannot, we think, be taken to have had that as a subconscious or unarticulated purpose.

Issue 2: Was the expenditure incurred for the purposes of Alliance & Leicester Building Society's non-trading activities as a holding company?

34. The Inland Revenue point to the last of the reasons in Appendix 1 to the papers considered by the Board at the meeting of 25 January 1996 ("Appendix 1"). Under the heading "Improved efficiency through simplifying and integrating operations", are these words:

"Conversion will give the opportunity of further integration of activities currently carried out in the Society and

Girobank."

The Inland Revenue referred also to a passage in the Transfer Document (section A) where it sets out the disadvantages of staying mutual or of merging with another mutual building society or adopting some other structure. Under the heading "Business development" this "disadvantage" is spelt out -

"Not facilitating the Society's desire to optimise its own internal operations, by moving the operations of the Society and Girobank under the supervision of a single principal regulator. Although significant progress has been made in integrating the two businesses, there remain areas of overlap which cannot be eliminated under the present dual regulatory structure. For example, the Group would expect to be able to reduce the significant levels of surplus liquidity which Girobank currently holds and which, under current regulatory constraints, cannot be utilized by the Society."

Mr Pym dealt with the point in evidence (17/46). The first feature in the disadvantage was, he said, that Girobank was required by the Bank of England to have its own information technology (IT) department with named individuals who constituted its IT staff. They had wished to make their IT operations more efficient and it had been difficult to do so while they had certain staff labelled Girobank and certain staff labelled "Society". The second feature was the problem resulting from the Bank of England restrictions on Girobank's lendings, i.e. the restrictions on the amounts that could at any time be lent to Alliance & Leicester Building Society.

35. As regards the first feature, we accept that conversion may have been a way of enabling the group to have a single integrated IT department. But there was no positive evidence that this had been a purpose. And we cannot see that something as insubstantial as this (i.e. insubstantial in the context of the conversion of a group with net assets of some £22.5 billion) can have been a purpose either real or in the sense identified by the House of Lords in *Mallalieu v Drummond* [1983] STC 663. As regards the second feature, we have already observed (in paragraph 30 above) that Bank of England restrictions on the amounts that Girobank could lend to particular borrowers disadvantaged Alliance & Leicester Building Society which had to pay an additional amount of interest to other lenders whose funds had originated from Girobank in the first place. There is no suggestion, however, that Girobank, or the holding company activity, stood to benefit from Girobank's release from this Bank of England constraint (i.e. by reason of Alliance & Leicester's acceptance as a bank).

36. The other non-trading purpose alleged by the Inland Revenue to have been a purpose for the expenditure was

that conversion would enable Alliance & Leicester to raise capital more easily. We take it to be implicit in that argument that capital so raised would be employed for a non-trade, e.g. holding company, purpose rather than for the purpose of the core trade of lending and borrowing. A passage in Appendix 1 was referred to. This reads:

"As a plc Alliance & Leicester could raise capital more easily. It also would not be constrained by the ultra vires problems inherent in being a building society when considering the fit of acquisitions with its strategic direction. Alliance & Leicester would then be able to take advantage of opportunities as they fit its strategy rather than as they fit its legal powers."

The first advantage of conversion referred to in the Transfer Document had been "flexibility to raise additional capital to finance the Society's growth, both through acquisition and organically."

37. Mr Pym was asked if the board had any developments or acquisitions in mind; his answer (17/15) was that - "I do not think that there was anything specific at the time". He had referred to possible acquisition opportunities in these terms:

"We are increasingly going into retail deposit products which are linked to the stock market where you wrap an equity derivative into it, where you provide them with fixed rate savings. The complexity of that market has been increased significantly."

He explained that the board had had in mind the Abbey National acquisition of National & Provincial; an acquisition of that nature would have "provided a much wider retail savings business". So far, as we see it, Mr Pym was referring to the possibilities for expanding the provision of financial services generally. At a later stage in his evidence he accepted that conversion would give greater flexibility, particularly in the area of wholesale funding and in the ability to raise equity capital.

38. We have reviewed the board papers and the Transfer Document in an effort to determine whether a purpose for the incurring of the disputed expenditure was to benefit the group holding company activity; we have found nothing firm to go on. The most immediate evidence of the Board's purpose is seen in the minute of the meeting of 27 January 1996 where the Board agrees to proceed with conversion. This minute reads:

"(a) the Group Board accepted, in principle, the recommendations of the Board Steering Committee that the Board recommend to members conversion to plc status. This would be in the best long term interest of the Society, its members, customers and staff with the reasons set out

in the draft Press Release which would form the core statement for the rationale contained in the Transfer Document

(b) the draft Press Release, Questions and Answers leaflets and letter to members were approved;

(c) the summary of the rationale for conversion (Appendix 1 to the report) was endorsed it being noted that in addition to the principal reasons specified there were several subsidiary reasons which had been alluded to in the papers previously submitted to the Board (including, for example, the ability to retain quality staff and the greater ability to introduce changes to the way the group was structured).

The only directly relevant "reason" in the draft Press Release (Appendix 3) is -

"The greater financial flexibility available to a listed public company will enable (the bank plc) to raise additional capital to support its growth organically and potentially through acquisitions."

39. The totality of the evidence indicates to us that the board had nothing specifically in mind. Raising additional capital to generate organic growth through the development of existing financial services activities must have been a possibility in the board's mind. Raising additional capital to purchase companies and businesses whose activities would expand or complement the Alliance & Leicester's core business may well have been another possibility. But raising additional capital to enlarge or enhance the Alliance & Leicester's holding company undertaking is a quite different matter. There is no evidence that it had any aspirations to being a holding company; the companies in the group were there because their activities were complementary to the Alliance & Leicester's core business and, in most cases, because the BSA regime prohibited Alliance and Leicester from conducting those activities itself. The evidence does not therefore support the Inland Revenue's contention that benefiting the holding company operation was a purpose for which the disputed expenditure was incurred.

Issue 3: Was the disputed expenditure incurred for the non-trade purpose of resolving the perceived difficulty presented by the presence of customers who were members and customers who were not?

40. The Transfer Document states as one of the advantages of conversion -

"The Board wants to recognize separately the ownership rights of Alliance & Leicester's members, while continuing to provide for the varied financial needs of all its

customers."

The draft Press Release referred to in the minute of 25 January 1996 board meeting see paragraph 38 above) refers to the building society having -

"expanded its role beyond that of a traditional building society, becoming in particular a broadly based provider of personal financial services and, through its subsidiary Girobank, a provider of banking services to business. As (the building society) continues to grow, it will, in the long term, be more difficult to reconcile the interests of its building society members with those of its non-member customers."

The problem, as Mr Pym saw it (17/75) was that "from a practical point of view you cannot treat your customers as a privileged group and it was an anomalous situation". He explained in his witness statement that whilst the membership class was much the largest class of customers, it was not necessarily the most profitable or valuable segment of the Alliance & Leicester's customer base. In a competitive climate, he said, a business such as Alliance & Leicester's had to focus its attention on winning new customers which meant offering special terms for new business. It could not therefore continue to recognize its class of members of preferential customers. Conversion, Mr Pym said (17/106) removed from the directors the obligation they had "to exercise the fiduciary duty which was really very difficult to exercise".

41. Overall, it seems to us, the resolution of the perceived difficulty of dealing with both customers who were members and customers who were not had the effect of removing an impediment to the carrying on of the Alliance & Leicester's business. The board was, as Mr Pym said (and we accept this), exonerated from its fiduciary duty towards the members when conducting the trading operations and particularly when pricing products and services. Conversion had the effect of transforming the erstwhile members' interests into shares carrying rights that were separate and distinct from the rights that they might have as customers actual or potential. By this means the board became free to carry on the business efficiently and as they saw best without having to look over their shoulders at the rights of their members who happened to be customers. We are therefore satisfied that, to the extent that the expenditure was incurred in resolving the perceived problem, it was laid out wholly and exclusively for the purposes of Alliance & Leicester's trade. To put the point another way we are satisfied that the expenditure was not incurred for the non-trade purpose of effecting a change to the proprietorial interests in the business.

Issue 4: Was a purpose of the disputed expenditure to

enable value to be released to the members?

42. The Inland Revenue say that this was a purpose. Because it was a non-trade purpose the expenditure incurred on conversion is therefore to be disallowed. They refer to the Transfer Document which says -

"Conversion would give members the opportunity either to continue to own a stake in Alliance & Leicester, thereby enabling them to benefit from the growth of the business, or alternatively to realize the value of their ownership rights."

Similar wording is found in the draft "Press Release" referred to in the minutes of 25 January 1996 board meeting. Appendix 1 to those minutes states that the rationale for conversion rests on five main arguments of which the second is -

"Allow members to realize the value of their membership rights."

Mr Pym (17/97) said of that wording and the wording used in the Press Release that it had been written in that way to encourage members to vote for the resolution to convert. Without the feature that conversion gave the members the choice either to remain members or to sell their shares in the market, there would, he said in his witness statement, have been no incentive to turn out and vote. He had said in his witness statement that the board had been quite neutral about the effect of conversion upon membership, save only that it served to disentangle interests of members from interests of customers. He said that he had never regarded the provision of shares to members as an end purpose of the exercise and he was sure that no other Board member did either. We accept that evidence.

43. We note in this connection that nothing in the minute of Board discussions shows release of value to members as being a purpose of the conversion. At most it is identified as an effect of conversion in the draft Press Release and the passage from the Transfer Document set out above. The Board had received advice from the company secretary that it was the duty of the directors "to consider the best interest and future well-being of the Society having regard to the interest of both present and future members.": see the minutes of the Board meeting of 26 October 1995. Releasing value to members for its own sake would not, we think, be in line with that advice.

44. Taking the evidence as a whole we are satisfied that the possibility of release of value to members was seen as an effect of conversion. It was highlighted as an advantage because conversion could not have proceeded without the

requisite turn-out of voters (i.e. a simple majority of borrowing members with no minimum turn-out and a 75% majority of voting members with a 20% turn-out). It was not, however, the purpose or indeed one of the purposes for which the conversion expenditure was incurred.

The statutory cash bonuses : the "wholly and exclusively" issue

44. For the reasons given in paragraphs 94-97 of the Halifax decision we are satisfied that the statutory cash bonuses are not excluded from ranking as deductions by operation of section 74(1)(a); they represent expenditure laid out wholly and exclusively for the purposes of the Alliance & Leicester's trade.

Capital or revenue

45. The reasoning in the Halifax decision is equally applicable here. The conversion expenditure, other than the statutory cash bonuses, was all of a revenue nature and consequently is deductible in computing profits.

46. The expenditure incurred in paying the statutory cash bonuses (£17.9 million) was, again for the reasons given in the Halifax decision, disqualified from deduction both on general principles and as being "capital withdrawn from ... the trade": section 74(1)(f) of Income and Corporation Taxes Act 1988.

Conclusion

47. The appeal is allowed in part. All the disputed expenditure, other than that incurred in paying the statutory cash bonuses, is allowable as a deduction in computing the Alliance & Leicester's profits for corporation tax purposes.

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SPECIAL COMMISSIONERS

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