

CAPITAL ALLOWANCES - Purchase by a UK company of plant and machinery from XYZ, a non-UK corporation - Lease back by the company to XYZ - Sublease by XYZ to a subsidiary UK company - Various security arrangements entered into involving (inter alia) a Channel Islands company resulted in the whole of the purchase price for the pipeline paid by the company being deposited with that company with the result that the purchase price was not available to XYZ as vendor for immediate use - Claim by the purchaser UK company to writing down allowances in respect of its expenditure on the acquisition of the section of gas pipeline - Claim refused by the Inland Revenue - Capital Allowances Act 1990 section 24

THE SPECIAL COMMISSIONERS SpC 00300

ABC LTD Appellant

- and -

M

(HM INSPECTOR OF TAXES) Respondent

Special Commissioners: MR T H K EVERETT

MR M P CORNWELL-KELLY

Sitting in London on 16, 17, 18, 19 and 20 July 2001

Mr Graham Aaronson QC and Mrs Camilla Bingham, instructed by Denton Wilde Sapte, Solicitors, for the Appellant

Mr David Goy QC and Mr David Ewart, instructed by the Solicitor of Inland Revenue, for the Respondent

ANONYMIZED DECISION

1. ABC Ltd ("ABC") appeals against notices of determination of trading losses for ABC's accounting periods ended 31 December 1993 and 1994 and notices of assessment to corporation tax for the same periods.

2. In substance there is only one issue in dispute: Is ABC entitled to writing-down allowances in respect of its expenditure of £91,292,000 allegedly on the acquisition of certain plant and machinery.

3. The evidence before us consisted of numerous agreed bundles of documents together with oral evidence from each of the following persons given on behalf of ABC:

Mr B, a member since 1992 of the ABC Board of Directors and the executive group, which is the group of senior officers who are collectively responsible for the strategic management of ABC's business

Mr P, group treasurer of AB Plc from 1991 to 2000

Mr F, a director of XYZ (UK) Ltd ("XYZ (UK)"), a wholly-owned UK subsidiary company of XYZ ("XYZ").

4. Witness statements were provided by each of the witnesses and in addition a full transcript of the proceedings is available to the court should these appeals proceed further.

The facts

5. Bundle G put in evidence contains (inter alia) an agreed statement of facts which states as follows:

A. THE PARTIES AND THE PLANT AND MACHINERY

1. ABC is a company within the AB Plc group. It was incorporated in England and Wales under company number on 14 February 1967 and its registered office is at Its principal activity is the provision of asset-based finance, and it is a leading UK supplier of finance and operating leasing and lease purchase arrangements in the business finance sector. With its subsidiaries it has a current turnover of approximately £2bn, assets of approximately £7bn and over 700 staff located in the UK, France, Germany and Italy.

2. XYZ is a corporation incorporated in the European Union.

3. Between 1991 and 1993 XYZ built, with the assistance of a grant from the EEC, the plant and machinery which is in part the subject of this Appeal ("the Plant and Machinery"). The construction was financed by loans from a consortium of banks.

4. XYZ (UK) is a wholly-owned subsidiary of XYZ. It was incorporated in England and Wales under company number on 17 June 1993. Its registered office is at

B. THE ACQUISITION AGREEMENT

5. Under the terms of two acquisition agreements between ABC and XYZ dated 31 December 1993 ("the Acquisition Agreements") ABC agreed to acquire the Plant and Machinery from XYZ. The total purchase price specified in the Acquisition Agreements was £91,292,000.

6. On 31 December 1993 ABC made a CHAPS payment of £91,292,000 plus VAT to XYZ, ABC having borrowed the sum of £91,784,000 from AB Plc at a fixed rate of interest of 10.95% per annum.

C. THE LEASE, THE SUB-LEASE AND THE ASSUMPTION AGREEMENT

7. Under the terms of a lease agreement dated 31 December 1993 between ABC and XYZ ("the Headlease") ABC agreed to lease the Plant and Machinery to XYZ for a pre-primary period running from 31 December 1993 to 30 September 1995 and for a primary period running from 1 October 1995 to 30 September 2025. Thereafter, subject to the fulfilment of certain conditions, the headlease provides that the lease may be renewed for successive one year periods.

8. Under the terms of a sublease agreement between XYZ and XYZ (UK) dated 31 December 1993 ("the Sublease") XYZ agreed to sublet the Plant and Machinery to XYZ (UK).

9. Under the terms of an agreement between ABC, XYZ and XYZ (UK) ("the Assumption Agreement"), ABC agreed that it would make out invoices to XYZ (UK) in respect of payments falling due from XYZ under the headlease ("the Assumed Payment") and that XYZ (UK) would settle such invoices, thereby discharging XYZ's monetary obligations due to ABC under the headlease. In turn XYZ agreed that direct payments from XYZ (UK) to ABC would, to the extent of the amounts so paid, satisfy XYZ (UK's) monetary obligations to ABC under the sublease.

D. ARRANGEMENTS FOR THE TRANSPORTATION

10. Under the terms of an agreement between XYZ and XYZ (UK) ("the Transportation Agreement") dated 31 December 1993, it was agreed that XYZ (UK) would transport, handle and deliver gas to XYZ's order and receive payment from XYZ therefor. Payments due to XYZ (UK) under the Transportation Agreement fall to be made into a specified account held in the name of XYZ (UK) ("the Transportation Account").

E. SECURITY FOR THE LEASE AND TRANSPORTATION ARRANGEMENTS

11. Under the terms of a guarantee facility agreement and Deed of Guarantee between AB Plc ("AB") and ABC, AB guaranteed to ABC direct payment by XYZ (UK) to ABC of the assumed payments ("the AB Guarantee").

12. Under the terms of a deposit agreement ("the Deposit Agreement") concluded between XYZ and a company, D Ltd ("D"), XYZ deposited the sum of £91,542,000 ("the Deposit Sum") with D ("the XYZ Deposit").

13. As security for its obligation to XYZ (UK) under the Transportation Agreement, XYZ assigned its interest in the XYZ Deposit to XYZ (UK) ("the XYZ Assignment") and charged a current account held in the name of XYZ ("the XYZ Account") in favour of XYZ (UK).

14. XYZ (UK) executed a Deed of Indemnity in favour of AB and in support thereof :-

(a) it assigned to AB:-

(i) its interest in the XYZ Deposit;

(ii) its interest in the XYZ Account;

(iii) its rights under the Transportation Agreement; and

(b) it charged the Transportation Account in favour of AB.

15. Under the terms of a deposit agreement concluded between D and AB Finance Company (Isle of Man) Ltd ("ABFCIOM") (a subsidiary of AB resident in the Isle of Man) on 31 December 1993 D placed an amount equal to the deposit sum with ABFCIOM ("the Cash Deposit").

16. D executed a Deed of Indemnity in favour of AB in respect of AB's obligations under the AB guarantee and in support thereof, D:-

(1) Assigned to AB its rights to the cash deposit;

(2) Granted AB fixed and floating charges over all its

assets; and

(3) Charged in favour of AB the account with ABFCIOM containing the cash deposit

17. The existence of the Cash Deposit held by ABFCIOM (the benefit of which was assigned to AB by D) had the effect that the finance provided by the ABC group was weighted at 0% in AB's consolidated capital adequacy return when the leasing transaction was entered into.

We make the following additional findings of fact based on the evidence before us.

18. On 8 April 1992 Mr H, the Corporate Finance Director of AB's European Corporate Group, wrote to XYZ, for the attention of N, XYZ's financial director with a proposal. Its first paragraph reads as follows:

"Re: The Plant and Machinery (the project)

Further to our discussions regarding the above project we outline below and in the attached diagram and documents our proposal for achieving (1) medium term funding at a substantial margin below the current commercial cost of funds, and (2) an effective up-front substantial discount in the capital cost of the project."

19. On a date unknown but believed to be subsequent to AB's proposal to XYZ on 8 April 1992, PQR Ltd ("PQR"), the investment banking arm of the AB group, made a presentation to XCo in relation to the plant and machinery. The first page of the proposal contains the following:

"Further to our discussions regarding the above project we outline below, and in the attached diagrams and documents our proposal for the involvement of XCo as a financial investor.

At this stage our proposal is a preliminary structure which will need to be adapted and tailor made to suit XCo and XYZ in the light of your reaction and objectives concerning particular elements of our proposal. We would hope to achieve this through further discussion with yourselves over the coming weeks, so that appropriate commitment to the structure from the relevant parties may be in effect by the end of July 1992. Our proposal, although using a number of projects which have the benefit of being relatively standard in the financial markets combines them in a way which is proprietary to AB, and accordingly we should request you to treat the structure and transaction with an appropriate level of confidentiality. We should also state that our proposed role is that of arranger of the transaction, and XCo should therefore seek its own legal,

accounting, and financial advice as it deems appropriate.

We have made the following basic assumptions:

- (1) The total cost of the project is circa £250,000,000
- (2) XYZ requires funding for circa eight years
- (3) XYZ is willing to involve another party in the legal and economic ownership of the project
- (4) There is an underlying commercial logic for the company in XCo's line of business to invest in this project
- (5) XCo is prepared to consider a financial investment and the commitment of tax capacity should the terms prove attractive."

ABC and PQR were each subsidiaries of AB plc at the relevant time.

20. The proposed deal with XCo did not proceed.

21. Subsequently PQR suggested to XYZ that it might consider entering into transactions with either YCo or ZCo. YCo was rejected as it had been established for less than six months.

22. On 23 March 1993 a presentation was made by the AB group of companies incorporating AB and PQR to ZCo.

23. The first page of the executive summary of that document (page 337 of bundle D2) reads as follows:

"Proposal

PQR and AB are proposing that a ZCo subsidiary enter into a finance lease as the lessor of the Plant and Machinery. The Plant and Machinery would be leased to a UK incorporated company which would be wholly-owned by XYZ. XYZ would assume responsibility for all risks associated with the ownership and operation of the Plant and Machinery.

In addition, PQR and AB will arrange funding and related agreements which will ensure that the substance of the following objectives are achieved for ZCo:

- (1) The investments are priced such that they are both remunerative and tax efficient, and will enable ZCo to

preserve a fixed level of return over its cost of funds;

(2) The principal credit risks involved in the lease are effectively transferred to third parties;

(3) PQR and AB will arrange and/or provide all the funding required for the investments;

(4) Risk asset weighting of the finance lease will be minimised."

24. At that time the total cost of the Plant and Machinery and facilities was to be circa £270,000,000. The finance lease envisaged a primary period ending in 2022.

25. The proposed transaction with ZCo did not proceed owing to legal advice to the effect that under its constitution XYZ was unable to give a guarantee.

26. On 15 September 1993 T and C of ABC wrote to the directors of the AB's Risk Management Department with a credit proposal (Bundle D2 at page 373). It reads as follows: -

"XYZ"

Attached is a £25m credit proposal bearing our qualified support in respect of a 31 year lease of plant and machinery to the above.

I apologise for the urgency of this application - PQR require an answer by Friday - but as you will see from the attached papers PQR's original lessor was dismissed by XYZ and in order to protect the AB groups' involvement in this remunerative and prestigious transaction we have been asked to step into their shoes.

The rationale for the proposal and the detail is set out in the attached papers. In summary we are being asked to provide a gross lease facility peaking at £177m (2010) of which the majority of the "quantified" exposure will be guaranteed by AB (cash collateralised), [our emphasis] but nevertheless involving a direct "strip" risk to the lessor culminating at £25m in the first few years of the next century. As with any lease we will in addition be exposed contingently to the lessee for adverse tax changes which cannot be specifically quantified but might involve an additional £15m exposure for each 5% increase in tax rate.

Whilst we wish to support this Group effort in consummating the transaction ABC are not in a position to analyse or recommend on exposure against the relevant EU member state country risk either in amount or time frame. To that end our recommendation is qualified on the basis that that credit approval must be forthcoming from the

appropriate specialist team within RMD. It is also fair to say that we would not normally wish to contemplate such a lengthy lease profile, but that as an exception we somewhat reluctantly support the term .

I can confirm however, and recommend on the following points:-

1. That ABC has the specialist team that will enable us to structure and document the lease in order to provide the maximum protection under the lease. (Wilde Sapte will act as our advisors)
2. Provided PQR supply the appropriate swaption then interest rate risk has been neutralised by fixed funding over the period.

On the above basis, and subject to clearance on the relevant EU member state country risk, the proposal carries our recommendation. Tax aspects are being covered separately."

27. XYZ (UK) has a board consisting of three directors (Mr F and two others) but apparently only one other employee. Most of its operations are carried out by the means of contracts with independent contractors. It is a £100 company. A letter dated 7 May 1993 (Bundle B2 at page 493AA) from the Financial controller of XYZ to a third party contains the following paragraph:

"Re: Sale/Lease Back of the Plant and Machinery

As previously discussed, the structure of the above requires XYZ to set up a subsidiary company incorporated in England that will lease the Plant and Machinery from the Lessor and will thereafter control all aspects of the Plant and Machinery over its useful life."

28. It is apparent from the evidence of B that ABC was aware that there were to be security arrangements for the lease and transportation agreements. In particular, ABC knew at the time that the transaction was entered into that there were to be a cash collateral equivalent to the price paid for the Plant and Machinery. (Day 2 page 60, lines 7-11).

29. Two versions of one document appear in the bundles. The document in question is a corporate certificate issued by XYZ. One version is to be found behind divider 40 in bundle B2 whilst the other version is to be found behind divider 35 in bundle C1. Each of the documents has exhibited to it an extract from the minutes of a meeting of the members of XYZ held on 14 December 1993. That

extract refers to a further exhibit entitled "Inter-Connector Proposal - Summary" if to be found at pages 566 and 567 in bundle B2 and at pages 262 and 263 in bundle C1. Those two versions are very different. The version in bundle B2 deals only with the sale of the Plant and Machinery, the lease and sublease, the guarantee by AB, the details of the eventual disposal of the plant and machinery by ABC and details of an access licence to be granted by XYZ to XYZ (UK). The version of the document in bundle C1 refers in detail to the security arrangements and contains (inter alia) the following:

"1. Deposit - XYZ will deposit the purchase price (to be paid to XYZ by ABC pursuant to the terms of two acquisition agreements in respect of the sale of the plant and machinery with D pursuant to a deposit agreement. The deposit is in legal terms a debt owed to XYZ by D i.e. a loan.

2. Deposit taker - D is to be a Jersey Limited liability company. The shares of D will be held by a Jersey charity trust. D is to deposit the XYZ deposit moneys with ABFCIOM (this document is not available to XYZ).

3. Deposit Repayments - Under the deposit agreement, D will repay to a XYZ account with AB (respectively the "XYZ account" and "AB") sums intended to match (both in timing and amount) [our emphasis] the rental and termination sums payable under an assumption agreement to be entered into between ABC, XYZ and XYZ (UK). In addition, on each rental payment date between October 1995 and October 2002 D will pay the XYZ "subsidy" to a separate XYZ account. ABFCIOM will be required to repay D's deposit with it in order to fund the payments due to XYZ.

4. Transportation Agreement - XYZ (UK) will transport gas to XYZ through the plant and machinery pursuant to a transportation agreement. Certain of the amounts payable by XYZ under such agreement are intended to match (both in amount and timing) [our emphasis] deposit repayments from D. Such amounts will be paid into a XYZ (UK) account with AB (the "XYZ (UK) Account"). As pre-conditions to the entry into of this agreement, XYZ (UK) is requiring XYZ to make its deposit with D and to charge its interest and rights in respect thereof and XYZ account in favour of XYZ (UK).

8. Cashflows - On each lease/sub-lease rental payment date the following payments intended to be of equal amount, will be made:

- (a) ABFCIOM to D in respect of D deposit into D's account;
- (b) D to XYZ in respect of XYZ deposit into XYZ's account;
- (c) XYZ to XYZ (UK) under the Transportation Agreement

into XYZ (UK's) account;

(d) XYZ (UK) to Lessor under the Assumption Agreement into the Lessor's account with AB".

30. The distribution list on each of the two above documents includes ABC. In a second witness statement of B he has stated his belief that "ABC was named as an addressee of this certificate by mistake and that it was never sent to ABC". He further stated "to the best of my recollection I had not seen the document (contained in bundle C1) before the hearing of this appeal."

As B was not cross-examined on the contents of his second witness statement referring to the above documents we must accept his supplementary evidence at face value.

as of

The document contained in bundle C1 is dated as follows "dated ~~this~~ 31 day of December 1993". The document contained in bundle B2 is dated 31 December 1993.

31. The Deposit Agreement dated 31 December 1993 and made between XYZ as Depositor and D as Deposit Taker contains the following provisions : (Bundle C1 at pages 110-111):

"3. DEPOSIT PAYMENTS

3.1 Subject to the Initial Deposit Amount being deposited in accordance with the provisions of Clause 2, the Deposit Taker hereby agrees, subject to the provisions of Clause 3.2, to repay the Deposit as follows:

(a) on each Payment Date which has an amount set opposite it in the second column of the Schedule, the applicable amount therein specified (a "Scheduled Repayment Amount A");

(b) (i) on each Payment Date which has an amount set opposite it in the third column of the Schedule, the applicable amount therein specified (a "Scheduled Repayment Amount B"); and

(ii) on each Payment Date which has an amount set opposite it in the fourth column of the Schedule, the applicable amount therein specified (a "Scheduled Repayment Amount C"); and

(c) on any day on which the Depositor and the Deposit Taker agree that the entire amount of the Deposit shall be prepayable (the "Early Termination Date"), the net amount equal to the value of the Deposit less the aggregate amount of the Early Termination Fees and the Breakage

Costs (each determined as of such date).

3.2 Save as set forth in this Clause 3, the Deposit Taker shall not be required to make any payment of any nature to the Depositor.

3.3 All payments to the Depositor pursuant to Clause 3.1 shall be made to account no. of the Depositor with EU Bank or to such other account or accounts as the Depositor may notify to the Deposit Taker from time to time."

32. The Account Charge Agreement dated 31 December 1993 and made between XYZ as chargor and XYZ (UK) as chargee contains the following provisions : (Bundle C1 at pages 194-5):

"4. Restriction on Withdrawals from the Charged Account

Subject only as is hereafter mentioned, XYZ shall not be entitled to withdraw or transfer any sums comprising the Charged Property.

5. Continuing Security and Enforcement of Security

5.1 XYZ hereby covenants with the Chargee that until the Chargee is satisfied that the Secured Obligations have been discharged in full, XYZ shall not withdraw any amount standing to the credit of the Charged Account nor shall it sell, assign, discount, pledge, charge or otherwise deal with or grant or permit third party rights to arise over or against the same or any part thereof or attempt or agree to do so; Provided Always that the Chargee may in its absolute discretion and upon such terms as it may agree consent to XYZ making a withdrawal of an amount from the Charged Account and Provided Always further that the Chargee shall consent to any withdrawal (each a "Permitted Withdrawal") from the Charged Account if:

(a) on the proposed date for the Permitted Withdrawal an amount shall be due and payable pursuant to the Transportation Agreement in respect of (a) Transportation Payment(s);

(b) the amount of the proposed Permitted Withdrawal is equal to the lesser of the amount then standing to the credit of the Charged Account and the aggregate amount of the Transportation Payment(s) due and payable on such day; and

(c) the full amount of the proposed Permitted Withdrawal shall be transferred directly from the Charged Account to the Chargee's Account."

33. A letter dated 31 December 1993 (Bundle C1 at page

244) signed on behalf of XYZ , AB and XYZ (UK) and addressed to AB contains the following:

"We refer to (i) the account charge agreement (the "Charge") dated even date herewith between XYZ as chargor and XYZ (UK) as chargee in respect of our account (the "XYZ Account") no. with the AB at the Branch and (ii) the assignment agreement (the "Assignment") also dated even date herewith between XYZ UK as assignor and the AB as assignee in respect, inter alia, of the XYZ Account.

AB and XYZ UK have agreed, notwithstanding any provision of the Charge or the Assignment to the contrary, that ABC may pay £91,292,000 (the "Funds") into the Account for value 31 December 1993 through the medium of CHAPS.

AB and XYZ UK have further agreed that, upon receipt of the full amount of the Funds, the full amount thereof may be debited from the XYZ Account provided that the same is immediately transferred to the account (the "D Account") no. of D Investment Limited ("D") with the AB at the Branch.

Accordingly we hereby instruct you that upon receipt in the XYZ Account of the full amount of the Funds, please debit the full amount thereof from the Account and pay this to the D Account."

34. A Memorandum of PQR dated October 1993 (Bundle D2 at pages 403-5) contains the following:

"(II) XYZ Deposit with D, D Deposit with ABFCIOM, D Indemnity and Security for Indemnity

A. XYZ Deposit with D

(i) XYZ will place a fixed rate deposit with D a company incorporated in the Isle of Man. D is a single purpose company owned by J as trustee for a charitable trust. J will appoint ABC to provide company management.

(ii) The terms of that deposit will be such that XYZ will be entitled to withdraw principal from time to time and receive interest and fees earned on the deposit during its life. This deposit will represent senior unsecured obligations of D.

(iii) XYZ can generate a cash flow through withdrawals of principal and receipt of income from the deposit sufficient to meet both its base case rental payments over the life of the Lease and also to provide it with some additional income.

B. D Deposit with ABFCIOM

D will place a deposit with ABFCIOM

D will provide an indemnity to AB in respect of AB's Guarantee of certain of the Lease obligations of XYZ. D will grant a charge to AB over its deposit with ABFCIOM as security for its indemnity obligations to AB.

In the normal course of its business, and as a matter of policy, all of ABFCIOM's deposit raisings are placed with AB Isle of Man Branch which in turn places its funds with GTS. The funds raised from the deposit by D with ABFCIOM will become part of the normal ABFCIOM raisings and will be dealt with in the usual manner described above.

In order to hedge its obligations to pay a fixed rate on the funds placed with it by ABFCIOM, AB IoM Branch will purchase a floor and will enter a swaption agreement with AB Swaps.

The result of the substitution of ABC in the structure is that the complications of the funding of ZCo are no longer required. The swaption written by AB Swaps and Options for ABC is hedged by the swaption written for ABPLC IoM Branch. However, we require confirmation of your approval for the provision of a cash secured guarantee to ABC for the fixed rental obligations of XYZ in the revised structure as described above."

(GTS represents AB's Global Treasury Services).

35. A XYZ Memorandum dated 14 December 1993 (Bundle D2 pages 415A-415E) contains the following:

"Plant and Machinery - Lease/Deposit Proposal

Introduction

(all figures in the Introduction are present value at 6.75%).

Relative to the lease/deposit proposal discussed with the Board at its meeting on 30 November 1993, the current proposal is less attractive to XYZ because EU member state stamp duty of circa £1.8 million will be payable which is partially offset by an increased subsidy of £0.9 million.

From the EU member state perspective the proposal is financially more attractive by the following:

(a) Net benefits have increased by £0.5 million in the first 8 years and by a further £0.4 million over the life of the lease.

(b) XYZ is not contributing to the cost of the floor.

(c) XYZ will receive the value of the floor in the event of

termination of the lease due to significant adverse rental movements.

(d) AB will guarantee a minimum value for the floor of £1.5 million in the event of termination due to denial of capital allowances in October 1995.

The package is worse from the EU member state prospective to the extent that termination cost has increased by £1.1 million (due to the cost of the floor).

The main elements of the lease/deposit proposal are outlined below.

1. Amount:

U.K. £91.3m

2. Effective Saving:

The gross value of the saving is estimated at £12.6m over the life of the lease (£11.7m over years 1-8) and the present value at £9.9m (discounted at 6.75%). Out of these benefits XYZ must pay £1.8m of stamp duty. The net present value is therefore projected at £8.1m.

3. Lessor:

ABC Group ("ABC"), a leasing company ultimately controlled by AB plc.

4. Structure:

Lease

(a) XYZ sells identified parts of the Plant and Machinery to ABC.

(b) ABC leases the above to XYZ under a finance lease for a period of 31 years.

(c) XYZ will sub-lease these parts of the Plant and Machinery to XYZ (UK) Limited, under a finance lease for 31 years.

Guaranty & Deposit

(a) XYZ will place a fixed rate deposit of £91.3m (the sale proceeds) with D, a Jersey company owned by a Jersey charitable trust. This deposit will service the lease rentals as set out in the lease agreement and provide the income of £12.6m to XYZ over the life of the lease.

(b) AB trust will provide company management to D and

the money will be deposited in a AB subsidiary in the Isle of Man.

(c) Lease payments by XYZ to ABC (as set out in the lease agreement) will be guaranteed by AB. Any changes to the lease rentals because of Writing Down Allowances or Corporation tax changes will not be covered.

(d) AB will have a charge over the deposit as support for the AB guarantee of the lease payments.

5. Transportation Agreement:

XYZ will enter a take or pay agreement with XYZ UK, for the transport of gas. Payments will be made under this agreement irrespective of gas flows.

6. Comments

(a) Ownership of the plant and machinery

(1) For tax reasons XYZ cannot have a right to buy the Interconnector. XYZ does have the right, assuming it is not in default of its obligations, to act as the exclusive sales agent and can thereby sell it at market value to a XYZ subsidiary.

(2) If XYZ is in default of its lease obligations then XYZ can lose control over the pipeline

(b) Deposit Risk

Risks attach to the security of XYZ's deposit. This risk would most likely arise in the event of the collapse of AB.

(c) Benefit Risks

While the expected net present value of the benefits of the scheme is £8.1m (net of stamp duty) the actual benefits may vary. The major reasons for variation are: -

(1) Denial of allowances.

(2) Change in level of capital allowances.

(3) Changes in the tax rates.

(4) Imposition of Withholding Tax.

While the size of the benefits may either increase or decrease they are likely to remain positive provided : (See

Annex A).

(1) Allowances are not denied.

(2) Tax rates do not fall to below 20% in the first few years (currently 33%) or go above 50% in 2010 (see graph).

The major downside in the next three years occurs if capital allowances are denied and the lease is terminated. If this happened in October 1995 the maximum cost would be £7.5m. (Assumes no residual value in the floor to XYZ).

In the event that capital allowances were reduced to 10% in 1995 (currently 25%) or tax rates reduced to 25%, the net benefit to XYZ of the scheme would be reduced from £10.8m to about £6.2m. If Corporation Tax rates increase to 50% in the year 2010 then the benefit from the lease/deposit would be eliminated.

In the middle to latter part of the lease (1998-2025) a reduction in the rate of Corporation Tax will increase XYZ's benefit whilst an increase will reduce XYZ's benefits.

For changes in tax rates in this period to eliminate XYZ's benefit, tax rates would need to be greater than 60% in 2000 or greater than 50% in 2010 and sustained at these levels for the duration of the lease. (The graph in the Appendix shows the range of tax rates which would need to prevail to result in a net loss to XYZ from the transaction).

It would be extremely expensive for XYZ to arbitrarily terminate the lease during the first seven years of its operation.

Accounting Issues

In economic terms the present value of the lease payments and the amount on deposit are the same. However while in economic terms these items are offsetting for reporting purposes it will be necessary to show the level of the deposit and the amount outstanding under the lease in the balance sheet. In addition it may be necessary to note certain contingent liabilities. Craig Gardner are satisfied that the lease will not impact on XYZ's Profit & Loss account.

Overview

The expected benefits to BGE of the lease proposal amount to £8.1 million. The EU member state receives an additional benefit of £1.8 million.

There are risks associated with receiving these benefits, because XYZ is tied to a very long (31 year) lease. Over the next 5 years the benefits are likely to be positive provided

capital allowances are not denied. In the long term (10 years plus) there is much greater uncertainty, and then benefits could be eliminated in the event of sustained high tax rate regime e.g. because of tax rates increasing to over 60% in the year 2000 or 50% in the year 2010, and staying at those levels.

Documentation

Final documentation has today gone to DTEC. Some schedules have been revised as late as today. It may not be feasible to complete before the deadline of Monday 20th December.

Recommendation

It is recommended that the proposal be finalised.

36. ABC receives rental payments under the terms of its lease, but has to pay higher amounts to AB under the terms of its borrowings. The difference, according to the terms of the scheme prepared by PQR is to be funded by the capital allowances claimed.

37. The Transportation Agreement is designed to ensure that XYZ (UK)'s rental payments can always be met. The transportation payments by XYZ are designed never to be less than the amounts of rent due under the terms of the lease. Admittedly higher transportation payments can, and probably will be made. However, the effect of the agreement is that effectively XYZ finances the payment of its sub-lessee's rental payments.

38. Under the terms of the deposit with D, the only moneys which leave the AB Group are payments B and C, which are small in comparison with payments A. Payments A return to AB.

39. We find as a fact that the events of 31 December 1993 were pre-ordained and designed by PQR to be a composite whole.

40. By virtue of two put options each dated 31 December 1993 and made between S Ltd ("S"), ABC and XYZ, XYZ is given the right in return for payments of nominal consideration to sell the Plant and Machinery and its equipment to S at the conclusion of the term of the lease to XYZ. On the evidence of B, S was formed "specifically for the purpose of being able to grant a put option to AB in the event that we wished to exit the lease. The constraints we put around that and we satisfied ourselves on the fact that within the lease that S must remain a wholly-owned subsidiary of XYZ for the entire period that the put option is

live."

41. The transfer of ownership of the Plant and Machinery was effected by two bills of sale, each referable to the respective acquisition agreements. The bills of sale were not produced at the hearing as they remained outside the jurisdiction and in an unstamped condition. After hearing argument we indicated at the conclusion of the hearing that in the absence of the original stamped documents we were not satisfied that either a legal or equitable title to the Plant and Machinery had been made out by ABC and we adjourned the hearing to enable ABC to consider its position. Shortly thereafter ABC's solicitors Messrs Denton Wilde Sapte gave an unconditional undertaking to present the bills of sale for adjudication and stamping and to pay the ad valorem duty assessed together with any penalty due. In the circumstances the ownership of the Pipeline is no longer in issue.

42. Prior to the hearing there was the possibility that the Crown might put forward contentions on the basis of section 42 Capital Allowances Act 1990. Before the hearing commenced however it was agreed between the parties that the Revenue would take no point in relation to section 42 as such had been their practice at the time of the relevant transactions in 1993.

The Contentions of the Parties

43. Mr Aaronson's approach to this case is very simple as is illustrated by the opening paragraph of his skeleton argument where he says "there is nothing in this case, once the facts are sorted and understood." He says that what took place in 1993 was an ordinary finance lease transaction to be taxed and treated like any other.

44. Mr Goy, for the Crown, accepts that if we are to look at the transaction solely by reference to what ABC did then ABC must succeed in this appeal but the Revenue say that this is a wholly incorrect approach. The effect of the steps that ABC took in this transaction must be judged by reference to the entire transaction of which those steps form part, including the security arrangements. Mr Goy has submitted that when the entire transaction is looked at it can be seen that this is no ordinary finance lease transaction, principally because in the view of the Inland Revenue there was no finance. XYZ received the sum of £91,292,000 plus VAT for perhaps a millisecond but it was never able to get its hands on the money. Mr Goy does not allege sham but seeks to use the "new approach", as propounded in *W T Ramsay Ltd v IRC* [1982] AC 300; *Furniss v Dawson* [1984] AC 474 and subsequent cases.

45. Both Mr Aaronson and Mr Goy submitted written skeleton arguments which will be available to the court

should these appeals proceed further.

The law

46. Sub-section 24(1) Capital Allowances Act 1990 provides as follows:

"(1) Subject to the provisions of this Part, where -

(a) a person carrying on a trade has incurred capital expenditure on the provision of machinery or plant wholly and exclusively for the purposes of the trade, and

(b) in consequence of his incurring that expenditure, the machinery or plant belongs or has belonged to him,

(c) allowances and charges shall be made to and on him in accordance with the following provisions of this section."

47. The appropriate allowance claimed by ABC is an entitlement to a 25% writing down allowance.

Conclusions

48. When making his submissions Mr Goy characterised the acts and events relative to these appeals as "financial engineering". It is apparent that he did not intend that description to be complimentary but it is possible that such a description may not be entirely rejected by ABC. Those same words "financial engineering" are to be found adorning the document detailing the presentation by AB to XYZ in April 1992 (Bundle D2 at pages 265-276).

However, Mr Aaronson has submitted throughout that all that his client did in 1993 was to engage in perfectly normal everyday finance leasing. What then is finance leasing? Mr B defined it in his evidence at paragraph 17 of his witness statement in the following terms:

"The basic premise of the finance leasing industry is that lessors pass on the value of the capital allowances available to them in respect of the asset being financed to the customer. The customer gets the use of the asset concerned and pays rent at a rate which reflects the margin required by the Bank and the reduced funding cost to the Bank of providing lease finance as a result of the tax deferral benefit available."

It is common ground in this appeal that if we look at and are concerned with only what ABC did in 1993 it is inevitable that it will succeed in its appeals before us. Accordingly Mr Goy, for the Revenue, has maintained throughout that we must look at the whole of the events which took place on 31 December 1993 and that if we look at the whole transaction it will be seen not to be a normal

everyday simple finance leasing transaction. He has rejected any attempt to use pejorative language but it is inevitable that if the Crown is to succeed in these appeals it must establish that what occurred was a complicated, convoluted tax avoidance transaction.

It is plain on the face of the documents that the arrangements were organised and set in motion by PQR.

After several false starts involving XCo, YCo and ZCo we find the details of the scheme laid out with precision in PQR's memo of October 1993, to be found in Bundle D2 commencing at page 403. It refers to the lease and the AB funding from ABC Global Treasury Services. It refers to the deposit by XYZ. It refers to the terms of the deposit. It refers to how XYZ can obtain a benefit. It states at the top of page 405:

"XYZ can generate a cash flow through withdrawals of principal and receipt of income from the deposit sufficient to meet both its base case rental payments over the life of the lease and also to provide it with some additional income."

Thereafter it refers to the deposit by D with ABFCIOM. It further states that the ABFCIOM deposit will be placed with AB.

In addition, there is a XYZ Memorandum dated 14 December 1993 to be found in the same bundle commencing at page 415A and at the top of page 415B details of the effective saving to XYZ is stated as follows:

"The gross value of the saving is estimated at £12.6m over the life of the lease (£11.7m over years 1-8) and the present value at £9.9m (discounted at 6.75%). Out of these benefits XYZ must pay £1.8m of stamp duty. The net present value is therefore projected at £8.1m."

In the light of all the evidence placed before us we must reject Mr Aaronson's submission that we should look no further than the actions of ABC. We accept Mr Goy's submissions in the light of the decisions in *Ensign Tankers (Leasing) Ltd v Stokes* 64 TC 617 and *MacNiven v Westmoreland Investments Ltd* [2001] STC 237 that section 24 is looking at a commercial concept. We also accept his submission that we must look at the whole of the transaction; all the documents, acts and events of 31 December 1993 and not merely what ABC did: *Overseas Containers (Finance) Ltd v Stoker* 61 TC 473.

Although ABC took no active part in the "security arrangements", we have found from the evidence of B that ABC knew that there were such arrangements, including the 100% cash collateral (Day 2 page 60 lines 7-11). We accept that ABC may not have known all the intricate

details of the security arrangements put in place but it was part of a larger organisation, namely the ABC Group of Companies, for both ABC and PQR, although operating to a considerable extent independently, were each subsidiaries of AB. We also accept Mr Goy's submission that in the light of the decision in *Moodie v CIR* 65 TC 610 detailed knowledge of all the subsequent transactions is not required of BMBF. At page 62ZD of the report there is the finding by the Special Commissioners that:

"Mr Moodie did not know the full details of the circular movement of debits and credits in the books of the Slater Walker Companies; but he knew that the financial arrangements would take place within the Slater Walker Group."

Mr Moodie's lack of detailed knowledge did not assist him in attempting to win his appeal before the House of Lords. We believe that for us to ignore the security arrangements merely because ABC may not have had full knowledge of the details of them would be to look at the transactions before us wearing blinkers and we reject Mr Aaronson's attempts to persuade us to do so.

It is common ground in these appeals that money by way of security was held in a loop. Mr Aaronson submits that it was by way of security only. Mr Goy accepts that security was involved but that that was only part of the story.

We also understand that there is no dispute that XYZ was unable, in Mr Goy's words, to get its hands on the money. In relation to that we are grateful to Mr P, a very experienced banker, who said in relation to a loan on a cash secured basis where the security covers the whole of the loan that such a borrower "has not got any more money at the end than he had at the beginning". (Day 2 page 151 line 25).

Accordingly it is apparent that XYZ acquired no funds by selling its plant and machinery to ABC. The purchase price having been borrowed by ABC from AB left ABC and lodged momentarily in a designated account of XYZ. Thence it travelled by way of deposit to D and eventually returned to ABC Global Treasury via ABFCIOM. Those facts are not disputed by ABC but we do not accept the argument put forward on behalf of ABC that such a circular route followed by the money represented no more than was required in order to provide the necessary security.

The only benefit which XYZ obtained from the very complicated arrangements choreographed by PQR were amounts B and C paid to it under the terms of the deposit agreement. Payments of amount A returned eventually to ABC and from ABC to the Bank. XYZ was to benefit to an extent of £8.1m net and the EU member state government was to receive £1.8m in stamp duty. Those payments

would be financed entirely by United Kingdom taxpayers by means of the hoped for capital allowances. Without the capital allowances XYZ would receive nothing, for the amounts of the rents would increase to take account of the non-availability of capital allowances.

Looking at the matter in round we accept Mr Goy's primary submission that the payment of money by ABC, even if it is said to have involved ABC incurring expenditure, cannot be said to have been expenditure on the pipeline.

The payment by ABC to XYZ achieved no commercial purpose. Commercially driven finance leasing is designed to provide working capital to the lessee. But XYZ could not get its hands on the money. It parted with a valuable asset allegedly for £91,292,000 but received no immediate benefit from that transaction. It provided no finance to XYZ simply because the amounts had to be deposited as part of the arrangements with D to be repaid only in accordance with the deposit agreement with D.

Lord Templeman in *Ensign Tankers (Leasing) Ltd v Stokes* said at page 742I, when dealing with the predecessor of section 24:

"The section is not concerned with the purpose of the transaction but with the purpose of the expenditure."

In our judgment the purpose of the expenditure by ABC on 31 December 1993 was not the acquisition of the Plant and Machinery but the obtaining of capital allowances which would result in ultimately a profit to XYZ and fees payable to ABC and PQR. The transaction had no commercial reality.

What actually occurred was that ABC parted with money to D and received back in return payments from D. Certainly XYZ was never able to enjoy the alleged purchase price of over £92,000,000. What is more it never expected to do so as is plain from the documents put in evidence.

We do not say that ABC did not make any expenditure but any expenditure it made was not on the plant and machinery and thus ABC cannot satisfy the conditions laid down by section 24.

The appeals fail and we adjourn these proceedings to enable the parties to agree figures.

T H K EVERETT

M P CORNWELL-KELLY

SPECIAL COMMISSIONERS

SC 3036/01

Cases cited but not referred to in the Decision

Barclays Mercantile Industrial Finance Ltd v Melluish [1990]
STC 314

Inland Revenue Commissioners v John Lewis Properties Plc
[2001] STC 1118

Lupton v FA & FB Ltd 47 TC 580

NAP Holdings UK Ltd v Whittles [1993] STC 592

DTE Financial Services v Wilson [2001] STC 777

CIR v Burmah Oil Co Ltd 54 TC 200

Coates v Arndale Properties Ltd 59 TC 516

R v CIR ex parte Matrix Securities Ltd 66 TC 587