Neutral Citation Number: [2018] EWCA Civ 2348

Case No: A3/2017/1871

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)
MR JUSTICE BIRSS AND JUDGE COLIN BISHOPP
[2017] UKUT 176 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 31 October 2018

Before :

LORD JUSTICE PATTEN
LORD KITCHIN
and
LORD JUSTICE FLOYD

- -

Between :

THE BRAIN DISORDERS RESEARCH LIMITED PARTNERSHIP	**Appellant**
- and -	
THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Respondent**

- -
- -

David Southern QC (instructed by Greenwoods GRM LLP) for the Appellant
Kevin Prosser QC and **David Yates** (instructed by the General Counsel and Solicitor to HM Revenue and Customs) for the Respondents

Hearing date : 26 July 2018

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Judgment Approved

See **ORDER** at bottom of this judgment.

Lord Justice Patten :

Introduction

1. The Appellant, the Brain Disorders Research Limited Partnership ("the Partnership"), was established in March 2007 as part of a scheme promoted by Matrix Securities Limited ("Matrix") that was designed with the twin objectives of allowing substantial capital allowances to be claimed for expenditure on medical research and of obtaining tax relief for the members of the Partnership in respect of some £68.6m of pre-payments of interest included as part of the financing structure of the scheme. At least in its origin the scheme was based on the one considered by the Upper Tribunal (Tax and Chancery Chamber) in *Vaccine Research Limited Partnership* [2014] UKUT 389 (TCC).

2. In order to maximise the claim for capital allowances whilst still enabling the pre-payments of interest to be made, the Partnership capital of £122m (largely made up of bank borrowings) was paid to a captive SPV (Numology Limited) ("Numology") under a Research Agreement which required the SPV to undertake a specified programme of medical research in return for the sum of £122m but permitted the SPV to conduct the medical research through a specified sub-contractor (BRC Operations Pty Limited ("BRC")) at a cost of only £7.67m. I have used the figure of £122m because different figures appear in different places to describe the amount of the Partnership capital and what was paid to Numology. The balance of the £122m paid to the SPV was used to make the pre-payments of interest, to repay the principal of the bank loans and to pay fees. But the Partnership claimed capital allowances of some £120m on the basis that it had incurred this amount of capital expenditure on research when carrying on a trade.

3. The Appellant is the general partner of the Partnership and its limited partner members are all high net worth individuals who joined the scheme in order to obtain up-front tax relief which could be set against their other sources of income. The transactional arrangements necessary to implement the scheme took effect on 2 April 2007 when both the Research Agreement and the Research Sub-Contract were signed. HMRC refused to allow the Partnership's claim for capital allowances and the claims of the individual partners to interest relief on a number of grounds including that parts of the contractual arrangements in the form of the Research Agreement entered into between the Partnership and Numology were a sham and therefore of no legal effect; as an alternative to the sham argument that a claim for capital allowances could not extend beyond the £7.67m paid to the sub-contractor and used for medical research because the wider contractual arrangements (including the bank loans and the Research Agreement with Numology) fall to be treated as a single composite transaction under which the only expenditure incurred on medical research was the £7.67m; but that even this sum was not allowable because the Partnership was not at the time carrying on a trade to which the research and development related so that the expenditure was not qualifying expenditure as defined in s.439 Capital Allowances Act 2001 ("CAA 2001").

4. We are concerned on this appeal only with the question of capital allowances and in order to understand the issues which arise it is necessary to outline in slightly more

detail the contractual arrangements between the Partnership and Numology and the financing arrangements put in place between the individual partners and the banks involved, Schroders and Bank of Scotland. From March 2007 the law was changed in Schedule 4 to the Finance Act 2007 so as to limit to £25,000 the amount of capital allowances which could be set against the partners' other income in any one year. It was this legislative change which led to an alteration in the form of the scheme so as to introduce the loan arrangements necessary to fund the pre-payments of interest and to include a claim for interest relief as one of the fiscal objectives of the scheme. The original tax planning together with these changes are described in the decision of the First-tier Tribunal ("FtT") in this case (Judge Howard Nowlan and Ms Helen Myerscough ACA) released on 2 July 2015. For convenience, I will adopt the same course as the Upper Tribunal (Birss J and Judge Colin Bishopp [2017] UKUT 0176 (TCC)) and set out the summary of the scheme contained in the FtT decision. For ease of exposition, the transactions are summarised using simple numbers beginning with the capital contributed to the Partnership which is treated as 100 and the payment of £7.67m to BRC which is 6. In fact, as already mentioned, the individual partners contributed capital of £122m to the Partnership of which £106.7m was provided by Schroders and Bank of Scotland by way of loan. The balance was provided by the partners out of their own resources. The FtT analysed these arrangements as follows:

> "6. The original objective of the tax planning was to identify an area of scientific research where the cost of a conventional research programme would be approximately ***100***, but where the technology, expertise, systems and data bank held by one particular company, would enable the relevant research to be undertaken and accomplished by that unique company for a vastly lesser sum, albeit that the company in question would retain 90% of any net royalties derived from the work programme to reflect the value of its special expertise, data bank etc held prior to the commencement of the research.
>
> 7. Without referring to the full detail of how the scheme might have proceeded, the original scheme envisaged that the partnership would pay ***100*** to a special purpose vehicle or SPV (in fact the Jersey company owned by a charitable trust, Numology Limited ("Numology"), that performed roughly this role in the *Vaccine Research* scheme). The ***100*** was said to be the reasonably verified amount that various third-party providers would have charged for undertaking the research work in the then conventional manner. Under the contract under which the Partnership paid the ***100*** to Numology, Numology contracted to undertake the work itself or through the identified sub-contractor, namely the company with the special expertise, systems and data bank referred to in the previous paragraph. That company was the Australian company, BRC Operations Pty Limited ("BRC"). In a research sub-contract, Numology then paid ***6*** to BRC to undertake the work programme that Numology had undertaken to perform or procure for the Partnership. The further terms of this arrangement were that BRC had licenced its existing intellectual property, its patents and knowhow, in

relation to the relevant area of scientific research, namely treatments for certain brain disorders, to Numology, and indirectly to the partnership for £1, and that had then been licensed back by the Partnership, first to Numology in return for a combination of fixed royalties and fluctuating royalties, and then sub-licensed by Numology to BRC in return simply for fluctuating royalties equal to 10% of the net royalties eventually derived from the improved and enhanced intellectual property following the work programme undertaken by BRC. Under this sub-contract arrangement, the deal with BRC was simply that if the completed work programme delivered royalties or any other reward, BRC would retain 90% of the net revenues, whilst 10% would flow to Numology and on to the Partnership

8. Since Numology had received ***100*** from the Partnership and applied only ***6*** in procuring that the scientific research would be undertaken by BRC, the basic plan (ignoring now irrelevant detail) was to be that Numology would acquire various deposits or other financial instruments with its retained ***94***, less whatever amount had to be paid in fees, to secure its obligation to pay the fixed royalties for which it alone was liable, as mentioned in the previous paragraph.

9. The tax hope and expectation on the part of the Partnership was that, since the partnership had paid ***100*** to Numology for the scientific research, (that amount being claimed to be what it would ordinarily have cost to undertake the research, and implicitly therefore fair payment), the partnership would be able to claim capital allowances for ***100*** and the partners would be able to set their respective shares of the allowances against other income. The tax benefit of that early tax relief, coupled then with the secured receipt of the fixed royalties meant that the transaction was appealing to the partners even if the research was unsuccessful, and no 10% royalties were ever received. Hopefully such royalties would be received. The expectation, however, that capital allowances would be available for the full ***100***, coupled with the secured receipts of fixed royalties that eliminated the more risky expedient of simply investing the entire partnership capital directly in scientific research was the objective of the planning.

The law change in March 2007 and the revisions leading to the scheme as implemented

10. On 2 March 2007, it was announced that partners would only be able to offset £25,000 of losses or allowances in this situation against other income and accordingly the planning had to be very materially altered.

11. Turning now to the revised scheme, and a simplified version of the actual transactions, the following steps were undertaken.

12. In order to contribute ***100*** (the eventual actual figure being £122,147,617) to the partnership, the partners borrowed ***43*** (£53,359,488) from each of two banks, Schroders and Bank of Scotland ("BoS"), these borrowings being arranged by Matrix and integral to the planning. The two borrowings thus provided ***86***, leaving each of the partners to contribute their share of the remaining required ***14***. Some of the partners funded their share of the ***14*** simply from available cash, whilst others borrowed from BoS. These borrowings, usually referred to as "top-up" borrowings, were not an integral part of the planning, and were simply ordinary bank borrowings, just as some of those partners contributing cash might in fact have borrowed from other banks.

13. There was some fairly irrelevant confusion, principally on the part of the Appellants, as to quite how fees and expenses had been incurred and satisfied. What we were initially told was that when the ***100*** had been contributed into the Partnership, ***4*** had been applied by the Partnership in meeting various expenses. Of the remaining ***96***, all of this was paid to Numology under the research agreement, under which Numology contracted to undertake or procure the completion of a designated work programme (various elements of the work being given assumed costings, with those costings aggregating to ***96***).

14. Having received the ***96***, Numology applied it as follows. While the initial envisaged profile of the fixed royalties payable to the partnership had been spread over the 15-year term which BRC had in which to complete the work programme, following the March 2007 law change it was decided that Numology should pay the partnership ***57*** immediately after the receipt of the ***96*** by Numology under the research agreement, as an advance payment of Numology's obligation to pay the fixed royalties mentioned above.

15. We will deal with the onward application of the ***57*** by the Partnership prior to describing how Numology disbursed its remaining ***39*** (i.e. ***96*** minus ***57***).

16. The terms of the Schroders loan of ***43*** were that the liability for the interest was a full recourse liability of the individual partners, whilst the liability to repay the principal was limited recourse, only to be discharged out of post-tax receipts of the 10% floating royalties or alternatively the sale proceeds to the Partnership of the licence and the right to the 10% royalties. No such sale was particularly envisaged, and while we will refer below to an option, this was not an integral part of the tax planning.

17. Immediately the partnership received the ***57***, by way of early receipt of the fixed rentals, the ***57*** was distributed to the partners, though in fact held at all times in an account in one or other bank.

40 was then immediately paid to Schroders, fully discharging the full recourse liability to pay the entirety of the interest on the Schroders loan. The interest rate was of course considerably higher than that under the BoS borrowing because of the non-recourse terms as regards the principal under the Schroders loan, the BoS loan having no such term.

18. The remainder of the Partnership's, and the partners' early receipt of fixed royalty, namely ***17*** (i.e. ***57*** minus ***40***) was applied in pre-paying the entirety of the interest on the BoS loan, i.e. the loan of ***43***, and not the interest on any of the top-up loans.

19. Returning to the residue of the ***96*** held by Numology, namely ***39***, ***29*** was contributed to some form of deposit in another BoS Treasury company to secure (i.e. fully secure) Numology's remaining liability to pay the remainder of the fixed royalties to the Partnership over the 15-year term of the transaction, the pre-tax amount of those royalties on receipt by the partnership being sufficient to repay, and specifically designed and charged to repay, the outstanding principal of the BoS loan of ***43***. In contrast to the position in relation to the 10% royalties to be applied in repaying the principal of the Schroders loan, there was no provision for only the post-tax receipt of fixed royalties to be applied in repaying the BoS loan. The assumption had been that, because full capital allowances would have been received, either those allowances were later being reversed by the receipt of the fixed rentals, or indeed if the losses derived from the capital allowances were being carried forward they would simply be netted off against the receipt of the fixed royalties. In the event that no capital allowances had been secured and that the fixed royalty receipts received by the Partnership and distributed to the partners remained taxable, the entire receipts were to flow automatically in discharge of the BoS loan, and the partners would have to pay the tax on the royalties out of other funds.

20. Of Numology's remaining ***10***, ***6*** (the actual figure being £7,760,427) was paid to BRC under the research sub-contract; ***3*** was paid by Numology to Schroders for an assignment to Numology of Schroders' remaining rights under its loan (i.e. the limited recourse right to receive a repayment of the principal essentially from and only from the post-tax receipt by the partners of distributions to them of the fluctuating 10% royalties), and the remaining ***1*** was applied in meeting expenses.

21. The essence of the revised tax planning was of course that if there was a limit on the amount of losses derived from capital allowances that could be set by the partners against other income, it was preferable to diminish the net claim for such losses by arranging for the partnership to have a receipt of income of ***57***, such that the claim for the net loss was reduced (ignoring the claim for fees and expenses) to ***39*** (***96*** minus ***57***),

> with the claim for tax relief then hopefully being augmented by relief for ***57***, the entire receipt of ***57*** being applied in pre- paying interest on the Schroders and BoS loans."

5. It will be apparent from this summary that although the scheme as implemented incorporated the arrangements for additional borrowing and the pre-payment of interest by the members of the Partnership out of the fixed royalty income derived from the contract with Numology, it retained its original basic structure insofar as the Partnership paid the 96 to Numology for the latter's contract to carry out the research but, by way of the royalty licence and licence-back to Numology, acquired a contractual right to substantial fixed royalties that were payable regardless of whether the work carried out by BRC in fact generated any licence income. The fixed royalty payments were always intended to facilitate the repayment by the Partnership of the bank borrowings but under the modified scheme (with the obligation on Numology to make substantial fixed royalty payments at the start of the 15-year period) the scheme enabled the interest to be pre-paid in full so as to establish an immediate claim for interest relief.

6. There is no doubt that the structure and terms of these arrangements were intended to substantiate the claim for capital allowances and interest relief which was the purpose of the scheme and to enable the full recourse bank borrowings and interest to be repaid. For this purpose, as the FtT found, the monies advanced by Schroders and Bank of Scotland were always held in blocked accounts at those banks (regardless of whether the funds were held for or in the name of the Partnership, the intended partners or Numology) so that there was no possibility of their being used other than in accordance with the scheme.

7. The FtT in its decision also highlighted a number of features of the scheme as implemented which it regarded as odd or uncommercial. BRC had licensed any patents or other intellectual property arising out of its research back to Numology and the Partnership for the nominal sum of £1 subject to the licensing of these rights back to BRC via Numology in return for 10% of the net royalties eventually derived from any inventions or research. There is nothing unusual in a research company agreeing to share the future profits from its research with its funders but the payment to Numology of £122m on a non-refundable basis to fund research whose actual cost to Numology was known to be no more than £7.67m is not a commercial arrangement nor is the corresponding obligation imposed on Numology to make the substantial fixed royalty payments to the Partnership which were not and could not be financed by BRC and which were not calculated by reference to any assessment of the predicted value of the research project. The finding of the FtT (at [86] of its Decision) was that the initial payment of 57 was introduced following the March 2007 law change to enable the individual partners to pre-pay interest and that:

> "all the circulating payments that we have just dealt with (including of course the ***29*** and the ***3*** paid for the assignment of the Schroders loan) had no remote relationship to scientific research or indeed to "guaranteed fixed royalties" ***derived from*** scientific research."

8. The FtT also commented on the option granted to BRC to acquire the licence of its IP rights from the Partnership. The evidence was that this was included not for tax planning purposes but merely to protect the value of BRC in the event that it became

the subject of a bid. But the option price was either market value or (if the research programme was still uncompleted) the higher of market value and the amount paid by the Partnership to Numology for the research rather than what Numology had paid to BRC to acquire its 10% interest in future royalty income. It was also a term of the arrangement that if the option ever came to be exercised so that the Partnership came to transfer back the IP rights for the option price, Numology nonetheless remained liable to continue to pay the balance of the fixed royalty payments. In relation to the floor price of BRC's call option, the FtT said this:

> "87. We accept that had BRC sought to buy out the Partnership's and Numology's 10% interest at a more sensible price, the Partnership and Numology might have been amenable to that. Nevertheless the reason why the floor price of the option had been [pitched] at the high level, when the aim was to return to the partners the realistic cost of the project, must have been that any other chosen floor price (geared for instance to the realistic cost of the scientific research) would have been inconsistent with the fictitious claim that the Partnership's relevant cost had been the high figure."

9. The other aspect of the scheme which calls for mention in relation to the commerciality of what was agreed is the provision that the £122m paid to Numology for the research programme was not refundable. This is in contrast to the Sub-Contract between Numology and BRC under which part of the £7.67m paid to BRC would become payable in the event that the research was not carried out or completed. At [89] the FtT said:

> "Equally everything in relation to the refund of the capital expenditure should the research project be abandoned was non-commercial. The term, and the requirement to repay some balance of the **6** at the BRC level was perfectly commercial, but the term of the top level research contract that provided that none of the ***100, 99*** or ***96*** should be refundable in any circumstances was uncommercial. It is obvious that when the ***57*** had been paid out immediately following the Day 1 payment to Numology, and the ***29*** and the ***3*** were irrevocably dedicated to their two objectives, none of those payments could possibly be refunded (on a failure by BRC to complete the work programme). The terms of the documentation providing, however, for a total non-refund in this situation (even of any realistic residue of the ***6***), was obviously explained by the fact that any partial refund of ***6*** would again have undermined the fictitious claim that the much higher amount had been paid by the Partnership to Numology for the scientific research."

CAA 2001

10. It is convenient to set out at this stage the relevant statutory provisions contained in Part 6 of CAA 2001. Section 437(1) provides that:

> "Allowances are available under this Part if a person incurs qualifying expenditure on research and development."

11. Research and development was defined at the relevant time in s.437(2) by reference to s.837A of ICTA but it is common ground that the work carried out by BRC was research and development as defined. The issues are what expenditure was incurred by the Partnership on that research and development and whether that expenditure was qualifying expenditure. This is defined in s.439(1) as follows:

> "(1) In this Part "qualifying expenditure" means capital expenditure incurred by a person on research and development directly undertaken by him or on his behalf if—
>
> (a) he is carrying on a trade when the expenditure is incurred and the research and development relates to that trade, …"

<u>The Decision of the FtT</u>

12. The rejection by HMRC of the claim for capital allowances proceeds at a number of different levels and a significant issue on this appeal is how, if at all, they relate to each other or have common features. The argument that clause 3.1 of the Research Agreement between the Partnership and Numology was a sham insofar as it provided that Numology should itself carry out the programme of research was deployed to meet the Partnership's claim that it had spent the whole £120m on research by the payment it made to Numology and not merely the £7.67m which Numology then paid to BRC. It was not contended by HMRC that if clause 3.1 was a sham in respect of the obligation by Numology to carry out the research (as opposed to carrying it out through an approved sub-contractor) that had the effect of invalidating clause 3.1 in its entirety and therefore defeating the alternative claim for capital allowances based on the expenditure of £7.67m.

13. In terms of outcome, the sham argument was therefore deployed as an alternative to what has been described as the quantum issue: namely whether on the true construction of s.437(1) CAA 2001, applying the approach to construction set out in the decision of the House of Lords in *W T Ramsay Ltd v Inland Revenue Commissioners* [1981] STC 174, the Partnership incurred any more than £7.67m in qualifying expenditure notwithstanding that it paid £122m to Numology under the Research Agreement for the research programme to be carried out. The FtT found that clause 3.1 was a sham insofar as it contained an obligation on the part of Numology to carry out the research itself but that, even if it was wrong about that, the only relevant expenditure for the purposes of s.437 CAA 2001 was the £7.67m paid to BRC.

14. The third point taken by HMRC was that whatever expenditure was incurred on the research and development it was not qualifying expenditure under Part 6 of CAA 2001 because the Partnership was not carrying on a trade relating to that research when the expenditure was incurred. At one level this is simply a question of fact. But it required the FtT as the fact-finding tribunal to identify what was the relevant expenditure. At the hearing before the FtT two possibilities were canvassed. The first (consequent on the FtT's findings about sham and quantum) was that the Partnership was not trading in respect of the £122m paid to Numology. The second was that it was not trading at

all (even in respect of the £7.67m) because its principal function or activity was a non-trading activity and that any relevant trading activity was between Numology and BRC in respect of the £7.67m paid under the Research Sub-Contract. The FtT concluded that the Partnership was not trading at all.

15. It is now accepted by the Partnership that for the purposes of s.437 CAA 2001 the various transactional steps comprised in the scheme (which in Mr Southern QC's submissions include the bank loans) fall to be treated not as separate transactional steps each with its own legal and fiscal consequences but rather as a single composite transaction under which the only relevant qualifying expenditure by the Partnership was the £7.67m paid to BRC. But, he submits, that same approach must also govern the question of qualifying expenditure so that it was impermissible (if that is what it did) for the FtT to ignore the separate existence of the Research Agreement and the Research Sub-Contract (or any of the finance agreements) for the purpose of determining what was the Partnership's expenditure on research yet to take into account the difference between the contractual positions of the Partnership and Numology when considering the question of trading.

16. The matter is further complicated, he says, by the fact that the finding of the FtT that clause 3.1 was in part a sham undoubtedly influenced its finding that the Partnership was not engaged in any relevant trade. He has therefore asked us to deal with the first ground of appeal challenging the finding of sham (which the Upper Tribunal has held was open to the FtT on the facts found) even though he is bound to accept that in the light of the Partnership's abandonment of its challenge to the decision of the FtT (affirmed by the Upper Tribunal) on the quantum issue, the sham ground of appeal has become academic in relation to whether the amount expended by the Partnership on research and development was the £120m or the £7.67m.

17. I propose to start with the trading issue and to consider as part of this whether and to what extent the decisions of the FtT and the Upper Tribunal depended either on treating the transactional components of the scheme differently from what is mandated by s.437 or on the findings of sham. I shall then consider whether and to what extent it is necessary or appropriate to examine the challenged finding that clause 3.1 of the Research Agreement was in part a sham.

Trading

18. The FtT held that there was no relevant trading activity at all by the Partnership in relation to the research and development carried out by BRC under the terms of the Sub-Contract. It will be recalled that the net effect of the licence arrangements was that BRC retained a right to 90% of any net revenue derived from the products of its research and Numology became entitled to fluctuating royalties equal to the remaining 10% of future net royalties from the research. The FtT's finding was that the possibility of a 10% royalty was not a significant factor in relation to the purpose of the scheme which was designed and marketed as a means of securing significant up-front tax relief from a combination of capital allowances and interest relief financed out of the large pre-payments of interest that were made possible by Numology's payment of the fixed royalties described earlier.

19. It set out its reasons for finding that the Partnership was not trading in respect of the £120m in [112]-[114] of its Decision:

"112. We conclude that the Partnership's total activity is not a trading activity. Everything in relation to the payment of the ***99*** or ***96*** that is destined to pay the ***57,*** the ***29*** and the ***3***, and the payment away by Numology of those three items, has nothing whatever to do with any trade. In reality there are major non-trading transactions undertaken in efforts to increase the allowances (by matching additional expenditure with so-called fixed royalties), and with a view to claiming relief for massive pre-payments of interest, and none of those transactions has anything to do with any trade.

113. It is actually difficult to say that any of the transactions just identified has very much to do with investment either, because there is absolutely no way in which any can generate any net investment return. It might be said that the ***57*** and all the later payments of the balance of the fixed royalties are an investment return. None of them produce an investment profit however. The ***57*** goes into the partnership and back to the partners, with no increment, and beyond being a step in a scheme to generate up-front tax savings from pre-payments of interest, the only implication of the movement of the ***57*** into and back from the Partnership is that if no capital allowances are available, and the **57** receipt remains taxable income (issue 10 in paragraph 32 above), the partners are landed with a tax liability, without funds to pay it, because the ***57*** was automatically and immediately applied in payments to Schroders and BoS. The same applies to any royalties paid out of the deposits funded with the ***29.*** Those deposits are fixed rate deposits, and our understanding of the figures is that in due course the fixed royalties funded out of the deposits will be exactly sufficient to repay the ***43*** of the BoS bank debt, but without any provision for any tax chargeable in respect of the receipt of the fixed royalties. The disbursement of the ***3*** by Numology, applied by Numology in purchasing the limited recourse right to the repayment of the Schroders debt, generates no conceivable return to the Partnership. All that it may do, assuming receipts of fluctuating royalties, is pass to Numology up to £53.4 million in debt repayment, at a loss to the partners, in terms of pre-tax flow of fluctuating royalties, of potentially about £97 million.

114. Whilst thus we fail to discern any possible investment profit that the Partnership or the partners might derive, our decision is nevertheless that all these money movements are nothing whatever to do with trading, but steps in a scheme designed to generate up-front tax savings. The fact that on the basis of our various decisions they will fail to do that, and at worst for the partners they might generate excess tax liabilities, has no bearing on this conclusion."

20. That left the question whether the payment of the £7.67m to BRC was nonetheless a trading activity given that, shorn of the additional loan and fixed payments designed to obtain interest relief, the fact remained that this sum was paid to BRC for genuine research in return for a share of future royalties. In the *Vaccine Research* case the FtT had been prepared to accept that the sum actually paid to the sub-contractor for the research and development could be qualifying expenditure. In the present case the FtT took a different view for the following reasons:

> "117. We are influenced by the marketing and the reality of this scheme which was that it was first and foremost a tax deferral scheme, coupled with secured receipts effectively just to pay off borrowings, and those two features were treated as the basis on which intending partners could sensibly join the Partnership, with the possible receipt of fluctuating rentals being a possible "add-on". Without them, however, the scheme was marketed on the basis that it was thought that everything made sense even if there were no receipts of fluctuating royalties.
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> 118. The next point is that, although the intellectual property is technically licensed to Numology and then the Partnership and then immediately licensed back to Numology and then to BRC, the substance is that an up-front payment is made for possible receipts of net royalties. The Partnership will in no way incur further costs in any trading venture. Many of the fees charged appear to be structuring fees, and certainly not fees that represent on- going expenses of a trade. Furthermore there is no active involvement that might occasion trading losses. There has simply been an up-front payment for a possible revenue stream and that does not appear to us to be a trading activity.
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> 119. We largely accept the Respondents' claim that at the outset the prospects of there being fluctuating royalties was highly speculative, and akin to a bet. This was not only the view of BRC in November 2007 when the document from which we quoted in paragraph 58 was issued, but this view tallies with the point made above in paragraph 117. This militates against the activity being a trading activity.
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> 120. Neither the Partnership nor Numology had any right of control over how BRC undertook its research project. The absence of any right of control is again a pointer against the trading analysis.
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> 121. The fact that a scheme may be a tax scheme may of itself have nothing to do with whether a participant in the scheme is trading, but when the efficacy of the tax scheme has resulted in the insertion of wholly non-commercial arrangements into the steps that might be trading transactions, this also militates against the trading analysis. We have already explained why we consider that the floor price in relation to the option, the feature that all the payments made by the Partnership to Numology are

> "non-refundable in all situations", and the way in which the payment of the ***3*** by Numology to Schroders appears potentially to deprive the Partnership of about £97 million of pre-tax royalties are all inexplicable on trading grounds. This is significant. It does not matter that the floor price in relation to the option, if exercised prior to completion of the project, is in favour of the partnership. The point is that the floor price is pitched at a ridiculous level for some ground that has certainly nothing to do with any serious trading considerations.
>
> 122. Our conclusion is that the Partnership is not trading at all."

21. Mr Southern made a number of specific criticisms of this reasoning. The task of the FtT, he submits, set by the legislation, was to identify the real transaction comprised in the scheme. To determine whether the £7.67m paid to BRC was qualifying expenditure it was necessary for the FtT to strip away those parts of the scheme including the finance arrangements and the provisions for the payment by Numology of fixed royalties and to concentrate instead on what the Partnership had actually spent on research and development. On the basis that the scheme arrangements fall to be viewed as a single composite transaction, the FtT should have ignored the interposition of Numology and applied its finding that the only sum expended by the Partnership on research and development was the £7.67m to the allied question of whether that was qualifying expenditure. Had it done so to the exclusion of the other parts of the scheme which on the *Ramsay* approach to construction fell to be ignored then it would have been left with its own findings in [44] of its Decision that the research undertaken by BRC was both highly competent and genuine and in [56]-[59] that there is a realistic expectation of the research producing a profitable return even if that was not apparent in 2007. Refined down to the essential elements of the payment of £7.67m to BRC to carry out research and development in return for a share of profits, Mr Southern submits that the FtT was almost bound to have concluded that the Partnership had in that respect embarked on a trade or an adventure in the nature of a trade as defined in s.832 ICTA 1988. Trading, he submitted, is not a legal test and it is irrelevant whether clause 3.1 of the Research Agreement was invalid as a sham or to consider more generally the financial engineering surrounding the relationship between the Partnership and BRC. Viewed simply in economic terms (as in relation to quantum), £7.67m of the Partnership capital was spent on research by BRC and the FtT should have concentrated on this in deciding whether it amounted to trading. He accepts that the mere payment of the £7.67m is not sufficient to make this a trading activity but the commercial reality was, he says, that the £7.67m was paid to generate future profits from the research and in that regard the Partnership and BRC were joint venturers. Motive and the wider context are irrelevant. To be trading one needs to identify a business carried on with a view to gain and that existed in this case.

22. The Partnership assumed the rôle of financier and leased back the IP rights to the producer in return for a share of the royalties. Instead of approaching the question in this way what the FtT did, says Mr Southern, as is apparent from [115]-[122] of its Decision was to concentrate on the circular financing arrangements which ought to have been ignored as self-cancelling just as they were for the purpose of determining the actual amount spent by the Partnership on the research. Most of the FtT's reasoning concentrates on the fact that this was a tax deferral scheme; on the fact that the possible

receipt of fluctuating royalties was an "add-on" and not essential to the marketing of the scheme; on the non-commercial arrangements for the payment by Numology of fixed royalties; and on the other non-commercial aspects of the arrangements referred to earlier in this judgment which are only explicable in terms of the tax objectives of the scheme. None of this was relevant to determine the statutory question of whether the £7.67m was qualifying expenditure. The FtT was wrongly influenced by the fact that the individual partners who invested in the scheme were only interested in obtaining the tax relief it offered and not in the profits from the research and development which were at best speculative in 2007. But at the heart of the scheme there was an agreement to finance the research and development in return for a share of the royalties which, Mr Southern submits, was trade. The FtT never, however, divorced that issue from the non-risk financing arrangements but instead relied on the latter to characterise every aspect of the scheme.

23. In support of his argument Mr Southern relied on a number of authorities frequently cited in relation to whether and, if so, how particular tax provisions should be construed as operating in respect of composite or connected transactions forming part of a tax scheme. In *Ensign Tankers (Leasing) Ltd v Stokes* [1992] 1 AC 655 the House of Lords considered a claim to capital allowances made in respect of a film scheme. The taxpayer company had entered into a partnership with an American film company to produce and exploit a film which was then in course of production. The partnership contributed $3.25m towards the cost of the film of which $2.3m was contributed by the taxpayer. The cost of producing the film was $14m and the production company agreed to lend the partnership the cost in excess of $3.25m. The loans were non-recourse and were to be paid out of 75% of the net receipts from the film with the remaining 25% being paid to the partnership as its share of the profits. The partnership sought to recover the whole US$14m cost of production as capital allowances. The claim was rejected by the Revenue and the Special Commissioners on the basis that the transactions were entered into primarily for fiscal motives and did not therefore amount to trade.

24. The House of Lords held that analysing the scheme on *Ramsay* principles as a single composite transaction the legal effect was that the partnership had expended $3.25m rather than $14m on the production of the film and was entitled to relief in the form of a first-year capital allowance provided that the expenditure was incurred by the partnership for the purposes of a trade. The principal issue which had been debated in the courts from the Special Commissioners up to the House of Lords with different results was whether for the purposes of s.41(1) of the Finance Act 1971 the partnership had expended $3.25m or $14m on the production of the film. This depended on whether one looked at the various component transactions (including the financing arrangements) individually or looked for those purposes at the ultimate legal and economic effect of the transactions. In the House of Lords this issue was resolved in favour of the Revenue on the basis that the 17 agreements involved were interdependent and constituted a single composite transaction. Lord Templeman (at page 665G-H) said:

> "When all the documents had been entered into, Victory Partnership was subject to an obligation to pay $3,250,000 to LPI and subject to an obligation whereby any money paid by LPI into the scheme current account was immediately transferred back to

> LPI. The financial consequence to Victory Partnership of its obligations under the scheme was the expenditure by Victory Partnership of $3,250,000. When all the documents had been entered into, Victory Partnership had a right to 25% of the net receipts from the exploitation of the film. The financial consequence to Victory Partnership of its rights under the scheme was the receipt by Victory Partnership of $3,000,000, being 25% of the net receipts from the film. The taxation consequences were that Victory Partnership, provided it were trading, generated a first-year allowance of $3,250,000 and Victory Partnership became in due course liable to corporation tax on the profits of $3,000,000 which it received."

25. The House of Lords also considered whether the partnership in *Ensign* had been trading in respect of the $3.25m. The Court of Appeal had remitted the case back to the Commissioners to decide whether the agreement with the production company was in the words of Sir Nicolas Browne-Wilkinson V-C "merely a device to secure a fiscal advantage or a genuine trading activity". Earlier in his judgment (see [1991] 1 WLR 341 at page 355) the Vice-Chancellor had said:

> "... if the commissioners find as a fact that the *sole* object of the transaction was fiscal advantage, that finding can in law only lead to one conclusion, viz. that it was not a trading transaction ... if the commissioners find as a fact only that the paramount intention was fiscal advantage ... the commissioners have to weigh the paramount fiscal intention against the non-fiscal elements and decide as a question of fact whether in essence the transaction constitutes trading for commercial purposes."

26. Lord Templeman took a different view. At page 677D he said:

> "My Lords, I do not consider that the commissioners or the courts are competent or obliged to decide whether there was a sole object or paramount intention nor to weigh fiscal intentions against non-fiscal elements. The task of the commissioners is to find the facts and to apply the law, subject to correction by the courts if they misapply the law. The facts are undisputed and the law is clear. Victory Partnership expended capital of $3¼m. for the purpose of producing and exploiting a commercial film. The production and exploitation of a film is a trading activity. The expenditure of capital for the purpose of producing and exploiting a commercial film is a trading purpose. By section 41 of the Act of 1971 capital expenditure for a trading purpose generates a first-year allowance. The section is not concerned with the purpose of the transaction but with the purpose of the expenditure. It is true that Victory Partnership only engaged in the film trade for the fiscal purpose of obtaining a first-year allowance but that does not alter the purpose of the expenditure. The principles of *Ramsay* and subsequent authorities do not apply to the expenditure of $3¼m. because that was real and not magical expenditure by Victory Partnership.

> The Vice-Chancellor referred to authorities in which intentions sometimes illuminated and sometimes obscured the identification of a trading purpose. But in every case actions speak louder than words and the law must be applied to the facts."

27. He did, however, accept as good law what Lord Reid had said in *Iswera v IRC* [1965] 1 WLR 663 where the taxpayer had acquired 2 acres of land in order to live near to her daughter's school and had disposed of the excess over what she needed in order to build a house. She was assessed to tax on the basis that she had traded in the land. Lord Reid said (at page 668) that:

> "If, in order to get what he wants, the taxpayer has to embark on an adventure which has all the characteristics of trading, his purpose or object alone cannot prevail over what he in fact does. But if his acts are equivocal his purpose or object may be a very material factor when weighing the total effect of all the circumstances."

28. The partnership in *Ensign* was held to have traded. Lord Templeman (at page 680B) said:

> "All these authorities were dealing with the identification of a trading transaction. In the present case a trading transaction can plainly be identified. Victory Partnership expended capital in the making and exploitation of a film. That was a trading transaction which was not a sham and could have resulted in either a profit or a loss. The expenditure of $3¼m. was a real expenditure. The receipts of $3m. were real receipts. The expenditure was for the purpose of making and exploiting a film and entitled Victory Partnership to a first-year allowance equal to the expenditure. The receipts imposed on Victory Partnership a corporation tax liability."

29. It seems to me right that the focus in any claim by a taxpayer for capital allowances in respect of expenditure under a composite transaction must be on what expenditure is found to have been incurred by the taxpayer on an analysis of the legal effect of the scheme and that the same must apply in relation to whether that expenditure is or is not qualifying expenditure. In *Ensign* the House of Lords therefore concentrated on the $3.25m for which the partnership was liable rather than the additional production costs of $11m which had been financed by way of non-recourse loans. It is also clear from the passage in Lord Templeman's speech dealing with trading that there can be a transaction in the nature of trade contained within scheme arrangements and that the intentions or motivation of the taxpayer may be close to irrelevant if the purpose of the transaction was clearly that of trade.

30. But it is also, I think, important not to read Lord Templeman's observations on this issue out of context. *Ensign* was a case in which the partnership between the taxpayer and the film production company directly financed the production of the film in return for a share of the receipts. Even when one strips away the loan arrangements made between the partnership and the production company which was intended to finance the

balance of the production costs, the partnership had still directly expended $3.25m on the project. It was not therefore difficult to conclude that the purpose of that expenditure was a trading one.

31. By contrast, the £7.67m paid to BRC for the research and development in this case was only qualifying expenditure if it was incurred by the taxpayer at a time when he was carrying on a trade in respect of it. Mr Southern's argument about the need to correlate the legal effect of the composite transaction with the question of whether the Partnership was trading assumes that the legal analysis involved has the effect of collapsing the Research Agreement and the Research Agreement Sub-Contract into each other and eliminating Numology in the process. If it does not have this effect then the argument goes nowhere because the only party in the transaction who paid money directly to BRC was Numology and it is, I think, common ground that it did so as a principal and not as an agent for the Partnership. Even if the finding of a sham is correct, it did not displace Numology in respect of its obligation to carry out the research via BRC and the fact that under clause 3.10 of the Research Agreement Numology assigned to the Partnership the benefit of its contract with BRC does not affect this analysis. The issue of trading calls, in my view, for an assessment of the actual arrangements which the parties put in place and the wider context in which the £7.67m came to be paid. It is a different question from what sum was actually expended on research and development for the purposes of s.437(1) and the court is not restricted to considering only those parts of the contractual arrangements which qualify for relief.

32. Neither the FtT nor the Upper Tribunal in this case has decided that on a purposive construction of s.437(1) the Partnership as opposed to Numology has incurred expenditure of £7.67m on research and development by BRC. The case for the Partnership remained throughout that it had spent the £120m it claimed as capital allowances on research and development in the form of the payment it made to Numology under the Research Agreement. It raised serious arguments based on the decisions of the House of Lords and the Supreme Court in *Barclays Mercantile Business Finance Ltd v Mawson* [2005] STC 1 and *HMRC v Tower MCashback* [2011] UKSC 19 to the effect that the whole £120m had been expended "on" research. All that the FtT and subsequently the Upper Tribunal have decided (and needed to decide) for the purposes of the quantum issue was that no more than £7.67m could be claimed by way of capital allowances because the £120m paid to Numology under the Research Agreement was not, on analysis, money that was expended on research within the meaning of s.437(1). Although the *Ramsay* approach to construction has undoubtedly involved the courts in looking at the commercial realities of the transaction and ignoring financial components of a scheme which are circular or have no purpose other than to produce a tax loss in order to identify whether and, if so, which parts of the transaction engage the relevant tax provisions, it does not enable the courts to fix the taxpayer with a contract which under the scheme it does not have. The actual transactions remain the same.

33. Although the FtT's analysis of whether the £7.67m paid by Numology to BRC could amount to trading by the Partnership takes into account a wide range of factors including the fact that the transactions existed as part of a tax deferral scheme, it seems to me that the FtT did address the real issue in [118] of its Decision where it makes the point that the Partnership incurred no further costs of any trading venture as a result of the fixed royalty payments made by Numology and had no active involvement with

BRC which could generate losses. Wider points were taken about the possibility of any return by way of royalties being highly speculative but the core of the reasoning is that the Partnership simply did not engage in any trading activity with BRC. As the Upper Tribunal put it in [56]-[57] of its Decision:

> "[56] …. Although we have found the FTT's reasoning a little difficult to follow in parts, we are satisfied that it took the right approach to answering the question whether the Partnership was trading, and reached a conclusion which was supported by the evidence. Had there been a straightforward contract between the Partnership and BRC for the undertaking of research in return for 6, with a sharing of any resulting royalties but without the involvement of Numology and the overlay of guaranteed payments, it might well be possible to reach the conclusion that the Partnership was trading despite the highly speculative nature of the transaction. But the proposition that the vast sum supposedly spent on research, whether that is taken to be 100, 99 or 96, was in reality incurred on trading activity is absurd.
>
> [57] … In our judgment the FTT's decision contains no error of approach and reaches a finding which was open to the tribunal on the evidence."

34. I agree with this analysis. The FtT and the Upper Tribunal concentrated on what the Partnership had spent on research as part of a trading activity. It had no direct contractual relationship with BRC other than by way of assignment and no legal control over whether BRC performed its own contract in accordance with its terms. Nor was the relationship one of principal and agent. One can perhaps look at the arrangements in terms of an investment by the Partnership in what BRC was doing but to describe it as a trading relationship between joint venturers is unsupportable on the facts which the FtT found and the contractual structure which the parties put in place. As Mr Prosser QC submitted, the contractual arrangements are inconsistent with this being a trading relationship and, when one takes into account the overall tax purpose of the arrangements, any equivocality is resolved against the taxpayer.

35. It follows that I do not accept Mr Southern's basic submission that to determine whether the only expenditure incurred ***on*** research and development is qualifying expenditure for the purposes of s.437(1) CAA 2001 the court is required to ignore the totality of the actual contractual arrangements. The House of Lords found that there was trading in *Ensign* because as part of the overall arrangements the Victory Partnership had nonetheless expended $3.25m on the production of a film. In this case the Partnership had expended its money under the contract with Numology on terms designed to obtain the tax benefits of the scheme and not in order to procure the 10% of any future royalties earned by BRC. The FtT was entitled to conclude from the arrangements as a whole that they did not include an adventure in the nature of trade with BRC and that the only significant returns from its point of view were the fixed royalty payments made by Numology which secured the repayment of the losses and the pre-payment of interest necessary to obtain interest relief. These were not generated by the research carried out by BRC and were financially independent of it.

36. That leaves the subsidiary question of whether the decision of the FtT on the trading issue was affected by its earlier finding that clause 3.1 of the Research Agreement was in part a sham. There is nothing in my view to support this criticism of FtT. The reasons set out in [115]-[120] of the Decision do not rely in terms on the finding of sham and I can see no basis on which to infer that it was a significant factor in the Tribunal's reasoning. In these circumstances, I do not propose to express any view about the correctness of the FtT's decision on the sham issue. If the expenditure was not qualifying expenditure because there was no trading it serves no useful purpose to consider an issue which is rendered academic by the concession about quantum and does not otherwise affect the outcome of the appeal.

37. I would dismiss the Partnership's appeal.

Lord Kitchin :

38. I agree.

Lord Justice Floyd :

39. I also agree.

ORDER

UPON THE APPEAL against the decision of the Upper Tribunal of 8 May 2017

UPON HEARING Counsel for the Appellant and for the Respondents

IT IS ORDERED THAT:

1. The Appeal be dismissed.

2. The Appellant shall pay the Respondents' costs of this Appeal, in the sum of £21,915, payment to be made within 30 days of the date of this order.

Dated 31 October 2018

David Southern QC David Yates

Counsel for the Appellant

Junior counsel for the Respondents