Appeal number: TC/2011/01672
TC/2012/03780

Capital allowances – LLPs – expenditure on software licences – ambit of closure notices – trading – incurring of expenditure - LLP as small enterprise – long life assets – anti-avoidance rules – main object of LLP

FIRST-TIER TRIBUNAL
TAX CHAMBER

DAARASP LLP **Appellants**
BETEX LLP

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE Rachel Short
Mr John Adrain (Member)

Sitting in public at Taylor House, 88 Rosebery Avenue on 15 – 23 January 2018 and 16 – 19 April 2018

Mr Andrew Thornhill QC and Mr Ben Elliott of Pump Court Tax Chambers for the Appellants

Ms Aparna Nathan, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. This is an appeal

(1) by the first Appellant, Daarasp LLP ("Daarasp") against a closure notice issued by HMRC on 26 January 2011 ("the Daarasp Closure Notice") amending Daarasp's loss figure in its partnership return for the 2003-2004 tax year from £18,192,004.00 to nil and

(2) by the second Appellant, Betex LLP ("Betex") against a closure notice issued by HMRC on 7 February 2012 ("the Betex Closure Notice") amending Betex's loss figure in its partnership return for the 2005-2006 tax year from £25,482,181.00 to nil.

2. Daarasp appealed against the Closure Notice on 21 February 2011 and did not request a statutory review. Daarasp's Notice of Appeal was lodged on 24 February 2011 and was acknowledged by the Tribunal on 18 March 2011.

3. Betex appealed against the closure notice on 2 March 2012 and did not request a statutory review. Betex's Notice of Appeal was submitted on 5 March 2012 and was acknowledged by the Tribunal on 29 March 2012.

4. The main issue in the appeals of both the Appellants is whether they are entitled to capital allowances under s 45 Capital Allowances Act 2001 ("CAA 2001") for payments made to acquire certain software licences.

The transactions which generated the disputed capital allowances

Daarasp

5. On 15 March 2004, a Partnership Agreement relating to Daarasp was signed by Peter Hargreaves, who became the Managing Member, and Piedama Limited ("Piedama") who became the General Member. The business of Daarasp was stated, in clause 2.1, to be "*the acquisition, development and exploitation of Software by providing data processing services (and cognate services) using Software*". Prospective LLP members were required to execute a Deed of Adherence in the form set out in Schedule 3 to the Partnership Agreement.

6. The following events occurred on 24 March 2004:

(1) S G Hambros London ("Hambros London") provided loan facilities to the prospective LLP members for their investment in Daarasp. These loans were to be guaranteed by an associate of the lender S G Hambros Bank and Trust (Jersey) Limited ("Hambros Jersey");

(2) A designer of computer software based in Pakistan, Parjun Enterprises, (the business name of a business owned by Mr Makhdumi) granted a 25 year licence

to exploit specific equity trading computer software ("the Daarasp Software") in all parts of the world with the exception of Australasia to Damats Limited, a BVI incorporated company ("Damats"). The consideration for this licence was £1.4 million;

(3) Daarasp agreed with Data Communication Control (Pvt) Ltd ("DCC") in Pakistan to provide hardware and technical support for at least three years in consideration of payment at a fixed US Dollar rate per trade.

7. The following events occurred on 26 March 2004:

(1) Daarasp acquired the 25 year software licence ("the Daarasp Software licence") from Damats in consideration of £18,188,244. Under the agreement, Damats guaranteed that the Daarasp Software licence would yield a minimum net operating income of £174,427 per quarter and a minimum net operating income of £21,925,000 over the term of the licence;

(2) Hambros Jersey provided a three year guarantee facility of up to £26,000,000 to Damats conditional upon the amount guaranteed plus 2.5% being held in an account with Hambros Jersey earning interest at 4% per annum ("the Jersey Account");

(3) Damats agreed with Hambros Jersey to assign all its interest in the Jersey Account to Hambros Jersey in respect of the loans made to prospective LLP members by Hambros London;

(4) Damats agreed with Daarasp that if any of the loans made to the prospective LLP members were outstanding after a period of three years, it would make loans ("Members' Secondary Loans") to the LLP members equal to the amounts of the loans outstanding. Interest would be chargeable on the Members' Secondary Loans at 4.75% per annum. The Members' Secondary Loans were repayable twenty two years from the date that the Members' Secondary Loans were made;

(5) Daarasp granted Parjun Enterprises an option to purchase the Daarasp Software licence between 26 March 2005 and 25 March 2009 for an exercise price set at £26,150,000;

(6) More than ninety individuals became LLP members by signing the Deed of Adherence;

(7) Daarasp appointed Mr John Curchod as Distributor of the rights to use the equity trading software for the UK and the Republic of Ireland for a minimum term of three months. Daarasp also appointed Mr Makhdumi and Dr Shaheen Ahmad as Distributors for a minimum term of three years for USA, Canada, Central America and the Middle East but excluding Turkey, Iran, Pakistan and India.

8. Mr Peter Hargreaves was involved in various capacities in the transactions;

(1) He was the Managing Member of Daarasp;

(2) The LLP members appointed him as their attorney under a Power of Attorney to act as their agent in carrying out all negotiations with Hambros London relating to the loans to the LLP members;

(3) He was a director of Damats;

(4) He signed the Deed of Agreement under which the software licence was sold by Damats to Daarasp on behalf of each of the parties to the agreement;

(5) He was the settlor and original trustee of the Dama Purpose Trust created on 24 February 2004 which owned Damats;

(6) He was also a director of Bedell Cristin Company Limited, Jersey which administered the Dama Purpose Trust.

9. Daarasp submitted a partnership tax return on 11 November 2004 for the year ended 5 April 2004. The Respondents issued a Notice of Enquiry to Daarasp on 22 December 2004. After a detailed review of Daarasp's partnership documents and other material relating to its claim for capital allowances under s 45 CAA 2001, and following discussions with Charterhouse Accountants LLP, ("Charterhouse") the promoter, the Respondents issued the Daarasp Closure Notice on 26 January 2011 disallowing the loss.

Betex

10. On 4 November 2005 the following events occurred:

(1) A Partnership Agreement relating to Betex was signed by Peter Hargreaves (who became the Managing Member) and Alan Dart (who became the General Member). The business of Betex was stated to be "*the acquisition, development and exploitation of Software by providing data processing services (and cognate services) using Software*". The software ("the Betex Software") provided on-line gambling functions. Prospective LLP members were required to execute a Deed of Adherence in the form set out in Schedule 3 to the Partnership Agreement;

(2) The Deed of Adherence was executed on behalf of 106 individuals by Peter Hargreaves acting as their attorney. These individuals thereby became new members (with capital contributions totalling approximately £23.5 million);

(3) Hambros London agreed to lend to Redbar Limited ("Redbar") as agent or nominee for the members of Betex, an amount up to a maximum of £20,150,000 for the purpose of contributing capital to Betex. The loan was for a maximum of two years from drawdown and carried interest at a rate of 5% pa;

(4) Hambros London agreed to lend Betex an amount up to a maximum of £39,000,000 for the purpose of acquiring the Betex Software from Piebet Limited ("Piebet"). The loan was for a maximum of two years from drawdown and carried interest at a rate of 5% pa;

(5) At the request of Piebet, SG Hambros Bank and Trust (Channel Islands) Ltd ("Hambros CI") agreed to guarantee the debt obligations of Redbar and Betex. In

return Piebet contracted to pay Hambros CI a fee of 0.1% annually, namely £59,150 p.a., of the total amount (£59,150,000) guaranteed, plus £250 per member of Betex. Piebet also agreed to give Hambros CI a counter-indemnity and security over its account which had to contain an amount equal to the outstanding loans plus a margin;

(6) Hambros CI and Hambros London entered into the "Set Off Agreement and Charge Over Deposit" Agreement under which Hambros CI agreed to deposit a sum equal to the "Collateral" (being a sum deposited by Piebet) in an account with Hambros London which would be subject to right of set-off in favour of the Bank following an event of default;

(7) On 18 June 2005 Piebet had been granted an option by Ecoholdings Media Group Limited ("EMG") in New Zealand for a premium of £1 to acquire the Betex Software licence in consideration of the payment of £65 million including initial consideration of £1,820,000.

(8) On 4 November 2005 (with no reference to the earlier option agreement) Piebet purchased the worldwide rights to the Betex Software from EMG, for an initial consideration of £1.6 million and a total consideration of £65 million. The terms of the sale provided that the software source code was to remain in escrow until the full consideration was paid;

(9) Betex purchased a licence of the software ("the Betex Software licence") for an initial consideration of £58,427,394. The licence was for a period of 24 years. The full consideration ("the Consideration") was stated to be £64,806,700. The terms of the licence granted exclusive rights to exploit the software worldwide if the Further Consideration was paid, but if it was not paid, the licence could not be exploited in Africa or South America;

(10) One of the warranties in the licence agreement warranted that the Betex Software would yield a minimum net operating income of "the Appropriate Fraction of £250,000 per quarter during the first two years and the Appropriate Fraction of £375,000 per quarter thereafter". The term, "Appropriate Fraction", was defined as, "the total Consideration received by the Grantor by 5 April 2006 or if earlier the end of the quarter concerned divided by the Consideration";

(11) Betex entered into an agreement with Interactive Gaming Systems Limited ("IGS") in New Zealand under which IGS was to provide technical support for the Betex Software. It also authorised IGS to use the Betex Software on behalf of Betex as its agent in order to fulfil those support obligations. IGS was to be paid a commission of 5% "of the commissions (net of any applicable taxes) paid in respect of each event by users (within the Territories) of betting exchanges utilising the Software during the relevant month";

(12) On 4 November 2005 EMG was granted an option by Betex to buy back the Betex Software licence at any time between 1 November 2006 and 31 October 2010 in consideration of £77.5 million;

(13) Piebet entered into a Secondary Loan Agreement with Betex under which it agreed:

"*In consideration of the sum of £40,300 now paid by the LLP to PIEBET (safe receipt of which PIEBET hereby acknowledges) PIEBET hereby agrees that in the event that there is a Deficit at the expiry of the Term on the Bank Loan it will make a loan to each Member of an amount equal to the Deficit on each respective Member's Loan on being called upon to do so by the LLP ("the Member's Secondary Loan")...".*

"Term" was defined as the period of 2 years starting with the Drawdown or if later the period ending with the due date of repayment of the Bank Loan. "Deficit" was defined as the balance from time to time due to the Lender by the Members in respect of the Bank Loan plus the interest outstanding thereon;

11. As a result of these transactions, EMG was entitled to £65 million from Piebet and received £1.6 million; Piebet was entitled to £64,806,700 from Betex and received £58,427,394. Piebet deposited the sums received from Betex into an account at Hambros CI as security for the loans to Betex and Redbar. The Betex Software was acquired by Piebet and was then licensed to Betex;

12. A second Deed of Adherence was executed on 20 March 2006: 19 new members were added and some existing members increased their capital contributions. The Deed of Adherence stated that the total capital contributions at that date were £26 million.

13. Mr Peter Hargreaves was involved in various capacities in the transactions:

(1) As the Managing Member of Betex;

(2) As attorney for the LLP members under a Power of Attorney to act as their agent to sign the Deed of Adherence and to sign any document required to obtain a loan from Hambros Jersey;

(3) As director of Piebet;

(4) As director of Redbar;

(5) As the settlor of "The Squirrel Trust" which owned Piebet. Further, the trust was administered by Bedell Cristin Company Limited, a Jersey company of which Peter Hargreaves was one of the directors.

14. Betex submitted a partnership tax return on 22 September 2006 for the year ended 5 April 2006. The Respondents issued a notice of enquiry to Betex on 31 October 2006. After a detailed review of Betex's partnership documents and other material relating to Betex's claim for capital allowances, and following discussions with representatives of the taxpayer, the Respondents issued the Betex Closure Notice on 7 February 2012 amending the loss shown in the partnership return to nil.

The law

15. The parties agreed that the matter in dispute is whether each of the Appellants are eligible for capital allowances under s 45 of CAA 2001 in respect of the payments made

by each of them to acquire the Daarasp Software licence and the Betex Software licence.

16. S 45 CAA 2001 states:

"45 ICT expenditure incurred by small enterprises

(1) Expenditure is first-year qualifying expenditure if—
(a) it is incurred on or before 31st March 2004,
(b) it is incurred by a small enterprise,
(c) it is expenditure on information and communications technology, and
(d) it is not excluded by section 46 (general exclusions) or subsection (4) below.

(2) "**Expenditure on information and communications technology**" means expenditure on items within any of the following classes.

Class A. Computers and associated equipment

This class covers—
(a) computers,
(b) peripheral devices designed to be used by being connected to or inserted in a computer,
(c) equipment (including cabling) for use primarily to provide a data connection between—
(i) one computer and another, or
(ii) a computer and a data communications network, and
(d) dedicated electrical systems for computers.
For this purpose "**computer**" does not include computerised control or management systems or other systems that are part of a larger system whose principal function is not processing or storing information.

Class B. Other qualifying equipment

This class covers—
(a) wireless application protocol telephones,
(b) third generation mobile telephones,
(c) devices designed to be used by being connected to a television set and capable of receiving and transmitting information from and to data networks, and
(d) other devices—
(i) substantially similar to those within paragraphs (a), (b) and (c), and
(ii) capable of receiving and transmitting information from and to data networks.
This is subject to any order under subsection (3).

Class C. Software

This class covers the right to use or otherwise deal with software for the purposes of any equipment within Class A or B.

(3) The Treasury may make provision by order—
(a) further defining the kinds of equipment within Class B, or
(b) adding further kinds of equipment to that class.

(4) Expenditure on an item within Class C is not first-year qualifying expenditure under this section if the person incurring it does so with a view to granting to another person a right to use or otherwise deal with any of the software in question."

17. Section 44 CAA 2001 provides:

"44 Expenditure incurred by small or medium-sized enterprises

(1) Expenditure is first-year qualifying expenditure if—
(a) it is incurred by a small or medium-sized enterprise, and
(b) it is not excluded by subsection (2) or section 46 (general exclusions).

(2) Long-life asset expenditure is not first-year qualifying expenditure under subsection (1)."

18. Section 46 CAA 2001 provides (so far as relevant):

"**46 General exclusions applying to sections 40, 44 and 45**

(1) Expenditure within any of the general exclusions in subsection (2) is not first-year qualifying expenditure under any of the following provisions—

section 40 (expenditure incurred for Northern Ireland purposes by small or medium-sized enterprises),

section 44 (expenditure incurred by small or medium-sized enterprises),

section 45 (ICT expenditure incurred by small enterprises)...

section 45A (expenditure on energy-saving plant or machinery)

section 45D (expenditure on cars with low CO2 emissions),

section 45E (expenditure on plant or machinery for gas refuelling station)

section 45F (expenditure on plant and machinery for use wholly in a ring fence trade)

section 45H expenditure on environmentally beneficial plant or machinery

(2) The general exclusions are—

General exclusion 5

The expenditure would be long-life asset expenditure but for paragraph 20 of Schedule 3 (transitional provisions)."

19. Section 90 CAA 2001 provides:

"90 **Long-life asset expenditure**

"**Long-life asset expenditure**" means qualifying expenditure—
(a) incurred on the provision of a long-life asset for the purposes of a qualifying activity, and
(b) not excluded from being long-life asset expenditure by any of sections 93 to 100"

20. Section 91 CAA 2001 defines "long-life asset" in the following terms:

"91 **Meaning of "long-life asset"**

(1) For the purposes of this Chapter "**long-life asset**" means plant or machinery which—
(a) if new, can reasonably be expected to have a useful economic life of at least 25 years, and
(b) if not new, could reasonably have been expected when new to have a useful economic life of at least 25 years.

(2) "**New**" means unused and not second-hand.

(3) The useful economic life of plant or machinery is the period—

(a) beginning when it is first brought into use by any person for any purpose, and
(b) ending when it is no longer used or likely to be used by anyone for any purpose as a fixed asset of a business."
.

21. There are anti-avoidance rules at ss 213 – 218 CAA 2001 which will deny a taxpayer the right to claim first year allowances under s 45 in certain circumstances:

Section 213 CAA 2001 provides:

> "213 **Relevant transactions: sale, hire-purchase (etc.) and assignment**
>
> (1)For the purposes of this Chapter, a person ("B") enters into a relevant transaction with another ("S") if—
>
> (a) S sells plant or machinery to B,
>
> (b) B enters into a contract with S providing that B shall or may become the owner of plant or machinery on the performance of the contract, or
>
> (c) S assigns to B the benefit of a contract providing that S shall or may become the owner of plant or machinery on the performance of the contract.
>
> (2) For the purposes of this Chapter, references to B's expenditure under a relevant transaction are references—
>
> (a) in the case of a sale within subsection (1)(a), to B's capital expenditure on the provision of the plant or machinery by purchase,
>
> (b) in the case of a contract within subsection (1)(b), to B's capital expenditure under the contract so far as it relates to the plant or machinery, or
>
> (c) in the case of an assignment within subsection (1)(c), to B's capital expenditure under the contract so far as it relates to the plant or machinery or is by way of consideration for the assignment.
>
> (3) If—
>
> (a) B is treated under section 14 (use for qualifying activity of plant or machinery which is a gift) as having incurred capital expenditure on the provision of plant or machinery, and
>
> (b) the donor of the plant or machinery was S,
>
> B is to be treated for the purposes of this Chapter as having incurred capital expenditure on the provision of the plant or machinery by purchasing it from S."

22. Section 215 CAA 2001 provides:

> "215 **Transactions to obtain allowances**
>
> Allowances under this Part are restricted under sections 217 and 218 if—

(a) B enters into a relevant transaction with S, and

(b) it appears that the sole or main benefit which (but for this section) might have been expected to accrue to B or S, or to any other party, from—

(i) the relevant transaction, or

(ii) transactions of which the relevant transaction is one,

was obtaining an allowance under this Part."

23. Section 217 & 218 CAA 2001 provide:

"217 **No first-year allowance for B's expenditure**

(1) If this section applies as a result of section 214, 215 or 216, a first-year allowance is not to be made in respect of B's expenditure under the relevant transaction.

(2) Any first-year allowance which is prohibited by subsection (1), but which has already been made, is to be withdrawn.

(3) If plant or machinery is the subject of a sale and finance leaseback (as defined in section 221) section 223 applies instead of this section".

"218 **Restriction on B's qualifying expenditure**

(1) If this section applies as a result of section 214, 215 or 216, the amount, if any, by which B's expenditure under the relevant transaction exceeds D is to be left out of account in determining B's available qualifying expenditure.
D is defined in subsections (2) and (3).

(2) If S is required to bring a disposal value into account under this Part because of the relevant transaction, D is that disposal value.

(3) If S is not required to bring a disposal value into account under this Part because of the relevant transaction, D is whichever of the following is the smallest—

(a) the market value of the plant or machinery;

(b) if S incurred capital expenditure on the provision of the plant or machinery, the amount of that expenditure;

(c) if a person connected with S incurred capital expenditure on the provision of the plant or machinery, the amount of that expenditure.

(4) If plant or machinery is the subject of a sale and finance leaseback (as defined in section 221), section 224 or 225 applies instead of this section."

The authorities

24. We were referred to a number of authorities which considered:

(i) The definition of a "trade" for tax purposes and the carrying on of a business on a commercial basis with a view to profit:

(1) *Patrick Degorce* v HMRC [2017] EWCA Civ 1427

(2) *Eclipse Film Partners no 35 LLP* v HMRC (No 4) [2015] EWCA Civ 95

(3) *Samarkand Film Partnership No 3 & others v Revenue and Customs Commissioners* [2015] UKUT 211 (TCC) & [2017] EWCA Civ 77

(4) *Seven Individuals v Revenue and Customs Commissioners* [2017] UKUT 132 (TCC)

(5) *Ingenious Games LLP & Others v Revenue and Customs Commissioners* [2015] UKFTT 521

(6) *Vaccine Research Limited Partnership & Anor v Revenue & Customs Commissioners* [2014] UKUT 389 (TCC)

(7) *Inland Revenue Commissioners v Willoughby and related appeal* [1997] STC 995

(8) *Marson (Inspector of Taxes) v Morton* [1986] STC 463

(ii) What it means for expenditure to be "incurred" for capital allowances purposes:

(9) *Ensign Tankers (Leasing) Ltd v Stokes* (*Inspector of Taxes*) [1992] 1 AC 655

(10) *Tower MCashback* LLP v *Revenue and Customs Commissioners* [2011] UK SC 19.

(11) *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes*) [2005] 1AC 684

(12) *Berry v Revenue and Customs Commissioners* [2011] STC 1057.

(13) *David Price v HMRC* [2015] UKUT 164

(14) *Fidex Ltd v Revenue & Customs Commissioners* [2016] EWCA civ 385

(iii) On the definition of a small enterprise:

(15) *Hoardwheel Farm Partnership v HMRC* [2012] UKFTT 402(TC)

(iv) On the application of the anti-avoidance provisions:

(16) *George Wimpey & Co Ltd v Inland Revenue Commissioners* [1974] STC 300 & [1975] STC 248

(17) *Garrett Paul Curran* v HMRC [2012] UKFTT 517 (TC)

(v) In respect of the procedural issue concerning the Closure Notices:

(18) *Bristol & West plc v Revenue and Customs Commissioners* [2016] EWCA Civ 397

(19) *Tower MCashback v Revenue and Customs Commissioners* [2011] UKSC 19, [2008] EWHC 2387(ch); [2010] EWCA Civ 32

(20) *Towers Watson Limited v HMRC* [2017] UKFTT 0846 (TC)

Evidence

25. We heard extensive oral evidence over eight days, including the evidence of two expert witnesses, Mr Sykes (appointed by HMRC) and Dr Castell (appointed by the Appellants).

26. Of the witnesses who gave oral evidence, only one, Mr Hargreaves, was actively involved in the activities of the Appellants, as their Managing Partner. We did hear evidence from three other witnesses who were investors in one, or both, of the partnerships; Mr Lee, Mr Edmond and Mr Curchod (who invested in Pie 3).

27. The other witnesses whose evidence we heard were providing their services to the Appellants, either in the form of information technology expertise, (Mr Syed Ahmed, Mr Makhdumi and Mr Earle) or as distributors and promoters of the Appellants' investment opportunities.

28. Several of the witnesses were involved in more than one capacity with one or both of the LLPs; Mr Edmond was a partner at Charterhouse, the entity which promoted and structured the transactions and was also an investor in both of the LLPs.

29. There was no dispute that one of the main instigators of the Appellants' transactions was a Mr Michael Sherry, a barrister in London who originated the idea of acquiring software and promoting investment in it. Mr Sherry did not give evidence to the Tribunal.

30. The evidence which we heard was extensive, detailed and in some respects technically complex. No attempt has been made to reproduce all of that detailed evidence in this decision. For ease of reading the oral evidence has been set out by reference to the relevant points in dispute, rather than simply recorded in the order in which it was heard by the Tribunal.

31. The points in dispute are

(1) What issues can properly be considered as under appeal to this Tribunal taking account of the terms of the Closure Notices issued to the Appellants.

(2) Whether either Appellant carried on a trade at the time when qualifying expenditure on information and communications technology (the Betex Software licence and the Daarasp Software licence, (the "Software licences")) was incurred. For Daarasp this includes considering whether the transactions which it said it undertook in the relevant period did in fact take place. For both Appellants this includes asking if a trade was carried on at the time when, or during the accounting period when, the qualifying expenditure was incurred and whether activities were carried on on a commercial basis, by reference to the profits made in the relevant and subsequent accounting periods and the way in which the business was marketed and managed.

(3) Even if the Appellants were trading, whether the expenditure which they claim to have incurred on the Daarasp and Betex Software licences can properly be treated as incurred on those licences, taking account of the way in which the Software licences were valued and the way in which the expenditure was financed.

(4) Whether any expenditure incurred was incurred by a "small enterprise" under s 45(1)(b) CAA 2001.

(5) Whether the expenditure on the Daarasp Software licence was "long life asset" expenditure under s 44(2) CAA 2001.

(6) Whether the anti-avoidance rule at s 215 CAA is applicable to the transactions.

DAARASP

Documentary evidence

32. **Transaction documents to which the Tribunal was referred**

(1) Daarasp Limited Liability Partnership Agreement dated 15 March 2004 between Peter William Hargreaves as the Managing Member and Piedama as the General Member.

The business of the LLP is described at paragraph 2 as "*the acquisition, development and exploitation of Software by providing data processing services (and cognate services) using Software."* The target capital of the LLP is stated to be £28,000,000.

Details of the Secondary Loans are included in clause 7 – Profits and Losses including at 7.5.2 "*After the making of the Secondary Loans and until the Secondary Loans have been repaid, an amount of profit equal to the interest on the loans will be paid to the Secondary Loan Provider on behalf of the Members entitled to such profits to settle their interest payments*".

Clause 17 deals with the winding up of the LLP stating that the Software shall belong to the General Member subject to and charged with any remaining liabilities not discharged.

(2) Prospective Member Information Document (PMID) setting out the Daarasp LLP structure including

(i) a description of the Daarasp Software capabilities "*it will deliver to the LLP's customers data processing services comprising data analysis and data analytics for financial traders, together with routing to the most appropriate broker for transaction execution*" and stating that "*Participation in a Limited Liability Partnership is a business venture. It is not an investment and is not marketed as such*".

(ii) On the management of the LLP it is explained that "*The day to day management of the LLP will be under the control of Peter Hargreaves.....There will however be regular meetings of the Members to provide the strategic direction to be carried out by the Managing Member. These meetings will be held half yearly for the first four years and thereafter annually*"

(iii) The acquisition cost of the Software is stated as £27,811 million payable in full at the time of acquisition and The Proposal says "It is unrealistic in the information technology industry to expect an entity to generate funds to each member in the first twelve months while it is being marketed. Therefore it would normally be the case that losses will be generated in the first period of trading. Any such losses will be available to the Individual Members for offset against their income and gains" This is followed by an extensive description of the "Rules for Tax Relief" which extends over three pages.

(iv) The LLP Administration section says "*it is a requirement of the relevant tax legislation that Members have control over the business. Every substantive decision the LLP needs to make will be made with the consent of the Members. The Managing Member will carry out the instructions of the Members based on their decisions*"

(3) Projected return schedule – Daarasp Valuation of Software Licence Based on discounted cash flow applying both an 8% and an 18% discount rate over a 15 year term.

(4) Sample facility letter from Hambros London.

(5) Support Technology for Web Broker's TSZP Web Corp.

(6) Deed of warranty between Mr Makhdumi and Dr Shaheen Ahmad (the warrantors) in favour of Pie 3 and Charterhouse dated January 22 2004 that they will "*complete or cause to be completed such modifications to the Software as are necessary to put the Software into such a state and condition that it will be capable of being demonstrated on a server and of being run on a server as being ready to be used by an Application Service Provider in the provision of date, data analysis and decision analytics by not later than 12 February 2004"* and confirming that the Software currently belongs to Parjun Enterprises.

(7) Deed of Agreement between Daarasp and Damats dated 26 March 2004 for the sale of the Daarasp Software licence, including warranties given by Damats to Daarasp at Schedule 4 of the Agreement that the exploitation of the Software will yield a minimum net operating income of £174,427 per quarter and £21,925,000 over the term of the Licence. The Licence is described in Schedule 2 "*The Licence has a term of 25 years is worldwide [apart from Australasia] and grants the holder the exclusive right to exploit the Software"*.

(8) Agreement between Daarasp and DCC dated 25 March 2004 under which DCC agrees to run the Daarasp Software in hardware operated and maintained by DCC and to provide technical support for the Daarasp Software. The agreement has a minimum term of three years.

(9) Deed of Agreement dated 25 March 2004 between Parjun Enterprises and Damats.

(a) This agreement transfers the Daarasp Software from Parjun Enterprises to Damats through the grant of a licence over the software and the creation of a bare trust over all of Parjun Enterprises' "legal and beneficial interest in the Software" in favour of Damats. Damats has the right to assign, but not sub-licence the Software.

(b) The Initial Consideration is stated to be £1,400,000. The Agreement includes reference (at Schedule 3 – the Consideration schedule) to Damats contemplating selling the licence to Daarasp, the obligation to place a proportion of the consideration which it receives on deposit with Hambros, the withdrawal of funds from that account, the making of a loan to the Daarasp partners and the warranty payments.

(c) No reference is made to how the Consideration other than the Initial Consideration is to be paid to Parjun Enterprises.

(d) Schedule 5 includes details of the Software and its capabilities describing it as "*an integrated system (comprising various suites of programs) that delivers information data analysis and decision analytics and provides the quickest execution for financial traders; it collects real-time prices from exchanges as well as storing historical price data. It then calculates, in real-time, sophisticated pricing and correlation calculations guiding the investor to a deal/no deal evaluation. It then provides a route to the cheapest-to execute dealer making a price in the instrument.*

The Software does this faster than any other non-dedicated systems currently available. It does this in an innovative way by monitoring the usage patterns of the investor automatically guiding him to the next level of decision making research and enabling him very rapidly to make the deal/no deal decision....."

(10) Declaration of Trust dated 24 February 2004 by Mr Peter William Hargreaves setting up the Dama Purpose Trust.

33. **Ancillary documents**

(1) Accounts of Daarasp for the accounting period 17 February 2004 to 5 April 2004 and the period 6 April 2004 to 5 April 2005 which report (i) for the period ended 5 April 2004 an operating loss of £24,043 income from sales of £3,619 (fees from 1Ecomnet.com) (ii) for the period ended 5 April 2005 operating profits of £392,818, income from sales of £9,433 (including fees from 1Ecomnet.com of £4,612.99) and other income (including warranty income) of £805,650.

(2) Invoice for $6,758.00 between 1Ecomnet and Parjun Enterprises dated 31 March 2004 referring to a finance agreement between 1Ecomnet.com and Parjun Enterprises referring to "work performed to date" with a manuscript endorsement to credit a Daarasp bank account.

(3) List of trades from May 2004 to November 2004 provided by Mr Makhdumi said to relate to equity trades undertaken using the Daarasp Software.

(4) Letter from Michael Sherry to Mr Makhdumi dated 2 December 2003 explaining the need to insert an entity between him and the bank because of Parjun Enterprises not being incorporated and suggesting that a jersey trust is used for this purpose.

(5) Note of meeting of 15 January 2004 between Mr Curchod and Dr Shaheen Ahmad, saying

> "*Shaheen is the man who will drive what needs to be built, how it will be built and when it will be built*" and recording that "*I saw code for a prototype version of a stand-alone dealing system for an individual trader and a working example..... It is a very sophisticated mathematical model that would be used by professional dealers..... Shaheen says this prototype is only a few (3 -5 weeks) away from completion*" and as to the development of the system "*time to market is critical otherwise competitors will see the ideas and bring them to the market more quickly. The main development should happen over the next 15 months he feels"* and concerning the application of the software "*The first version of the system will immediately appeal to day traders and dealing desks. Hedge funds are an obvious target".* Finally the note contains some comments on the valuation of the Daarasp Software accepting that "*the version that exists today satisfies the requirements of a day trader. Over the next twelve months the system will be enhanced to cover the needs of a trading desk with an investment bank and thereafter extended to satisfy the need of high net worth private investors"* and concluding *"It is perfectly feasible that the cost of building a system available to Private investors in all the major markets of the world could push the development cost to £100 million"* and confirming that the system had been built in the US not Pakistan "*what exists today has all been built in the US*".

(6) Daarasp (Report) dated 25 January 2004 including "marketing strategy and development plan" and referring to payments made including $6,758 on March 31 for "trades on file in New York", stating that "trading floor now almost complete" (and attaching pictures) and a summary of transactions made on exchanges – "*USA – All to date, zero transactions in UK or Pakistan*" and under Discussions heading "*results are behind projections but efforts are underway to increase marketing effort therefore long term sales*".

(7) Note of meeting of 22 April 2004 between Mr Makhdumi, Mr Curchod Mr Edmond and Dr Shaheen Ahmad in Karachi, including statements by Dr Shaheen Ahmad that "*trade continues in the US*" and references to the need to provide an updated business plan and to understand who has responsibility for the implementation of marketing.

(18) Hambros London bank account statements for Daarasp of 16 June 2004 and 27 August 2004 showing receipt from 1Ecomnet.com of £3,618.55 paid on 16 April 2004 and of £4,612.99 paid on 3 August 2004.

(19) Letter dated 9 January 2004 from Jahangir Siddiqui and Co Ltd to Parjun Enterprises saying "*We write to confirm our interest in working with you for web based trading from overseas as well as the domestic market on the Karachi Stock Exchange"*

34. **Financing documents**

(1) Guarantee Facility from Hambros Jersey dated 26 March 2004 to Damats offering Hambros London a Guarantee facility of £26,000,000 for a term of three years and setting out the security arrangements in respect of the facility.

(2) Counter-indemnity Agreement between Hambros Jersey and Damats dated 26 March 2004 under which Damats agrees to indemnify Hambros Jersey for any money paid under the Guarantee Facility to Hambros London.

(3) Security Interest Agreement dated 26 March 2004 between Hambros Jersey and Damats assigning as collateral all monies in the S G Hambros Nominees (Jersey) account and giving Damats access to funds in that account only if they exceed the Security Amount, which is equal to the amount of the loan made under the Guarantee Facility plus accrued interest

(4) Secondary Loan Agreement dated 26 March 2004 between Damats and Daarasp providing that if there is a deficit under the loan agreements made by the LLP members with Hambros, Damats will make a loan to Daarasp of an amount equal to that deficit. Stating that if on the 25th anniversary of the drawdown of the Secondary Loans the loans have not been recouped in full, the members will be liable to pay Damats an amount equal to the amounts which Damats has not recouped.

(5) Option Agreement dated 25 March 2004 between Parjun Enterprises and Daarasp under which Daarasp grants Parjun Enterprises an option to acquire the Daarasp Software licence at any time between 26 March 2005 and 25 March 2009

by notifying Daarasp of its intention and paying the exercise price of £26,150,000.

(6) Daarasp Deed of Adherence dated 26 March 2004, setting out the names of the members wishing to join the Daarasp LLP

(7) Distributor Agreement dated 26 March 2004 between Daarasp and Mr Curchod appointing Mr Curchod as distributor of the Daarasp Software for a period of three months in the UK and Ireland, including a schedule of payment rates per trade.

(8) Distributor Agreement dated 26 March 2004 between Daarasp, Mr Makhdumi and Dr Shaheen Ahmad appointing them as distributors of the Daarasp Software for a minimum of three years in the USA, Canada, Central America, the Middle East (ex Turkey) Iran, Pakistan and India, including a schedule of payment rates per trade.

(9) Letter from Charterhouse to investing members dated 12 March 2004 detailing the operation of the Daarasp LLP and the proposed borrowing arrangements concluding that *"while they are full recourse loans, in practice sufficient funds will be generated either through trading or the warranty to enable interest to be paid on the members' behalf as it falls due. In addition, either the loan will be repaid in full over the term of the loan or, alternatively, as the end of 25 years the loan will be repaid and there will be a counterclaim under the warranty for an amount equal to the loan. The net effect of this counterclaim should be that you would not actually be called upon to repay the loan. Whilst is it not possible to make the loan non-recourse and totally risk free, to do so would prejudice the claim for loss relief, the reality is that the risk that you will be called upon to make actual personal repayments of the loan is very small"*

35. **Notes of meetings of Daarasp LLP members**

(1) Dated 24 February 2005 including a note of Mr Makhdumi's statement that:

> "*the principal delays in getting the product to market were regulatory- the Agents had underestimated the regulatory barriers to market access. They now believed that via an arrangement with a stock exchange member they would have access to the Karachi exchange by the end of April 2005*"

(2) Dated 1 September 2005 including a statement from the Chairman that:

> "*The Chairman confirmed that the LLP was profitable due to the level of warrantied income proving the robustness of the structuring promoted in the original information memorandum for the LLP*" and from Mr Makhdumi that "*the existence of competition meant that the LLP had underachieved against forecast*"

(4) Email of 29 March 2004 from Peter Hargreaves detailing the decision about the territorial scope of the Daarasp Software licence:

> "*Whilst I was in the UK on March 26 I telephoned Alan Dart and we agreed a verbal contract defeasible in the event insufficient is raised in capital contributions by the FAARDAR LLP by July 31 2004 for the Damats*

Limited to sell the licence for the DAAR software for the far east and Australasia to the FARDAAR LLP for the balance by which the amount paid by DAARASP LLP fell short of the full amount originally postulated for the acquisition of the worldwide licence"

(5) Minutes of meeting of Damats Limited 29 March 2004 recording at 1.2 Capital Contributions to the Daarasp LLP;

"*It was noted that the offer to raise capital contributions for the LLP had closed on March 26 2004 and the amount raised was £18,337,668"* and at 1.3 Acquisition of Software*: "As a result the consideration payable by the Daarasp LLP to the company was £18,188,244 and based on the formula set out at 3.2 of the minutes of the last meeting the initial consideration payable to the company Parjun Enterprises would have been £1,176,520. However, a letter from PE a copy of which is attached to and forms part of these minutes had indicated that PE would accept a minimum initial consideration of £1.4m. In the circumstances the licence from PE to the company had been executed based on an initial consideration of £1.4m whilst the on sale to the DAARASP LLP had been executed based on consideration of £18,188,244.*

Furthermore whilst at the meeting held on March 20 2004 the directors noted that the reduced consideration would be payable on the basis of the 25 year software licence of the DAAR Software excluding Australasia, which they had assumed referred to Australasia and New Zealand. The letter from PE made it clear that Australasia meant the territories east of Bangladesh and up to Japan, Australasia and New Zealand"

36. **HMRC correspondence**

(1) Notice of Enquiry dated 22 December 2004

(2) Closure Notice dated 26 January 2011

(3) Letters to HMRC from Charterhouse dated 30 January 2008 (referring to the long life asset rules at s 90-92 CAA 2001), 27 January 2010 (referring to restrictions under s 48 CAA 2001) and 15 February 2010 (referring to s 214 CAA 2001).

Oral evidence

37. We saw witness statements from:

(1) Peter Hargreaves dated 21 January 2016

(2) John Curchod dated 7 March 2016

(3) James Edmond (first & second statements) dated 27 January 2016 & 12 July 2016

(4) Junaid Makhdumi (first & second statements) dated 30 January 2016 & 21 July 2016 & additional statement dated 22 March 2018

(5) Syed Qutub Ahmed dated 9 August 2016

(6) Expert witness report of Dr Stephen Castell dated 9 August 2016 (appointed by the Appellants)

(7) Expert witness report of Mr Anthony Sykes dated 11 August 2016 (appointed by HMRC)

(8) Joint expert statement dated 3 November 2016.

All of these witnesses also gave oral evidence to the Tribunal and were cross-examined.

38. At the start of the hearing we were shown a CD which recorded a "live" demonstration of a version of the equity trading software licensed to Daarasp being operated by a Mr Nisar in late 2015.

39. The content and functionality of the Daarasp Software in March 2004 was disputed by the parties. We have referred to "versions of the Daarasp Software" to avoid any suggestion that we have accepted that it is now possible to identify the version of the Daarasp Software which was available to users in March 2004.

Whether the transactions alleged by the Appellants took place

Did the Daarasp Software exist in functional form at the time when the partners made their investments in Daarasp at the end of March 2004?

40. The functionality of the version of the Daarasp Software which was available for use and exploitation under the licence granted to Daarasp in March 2004, at the time when the partners in Daarasp made their investments, was a matter which was strongly disputed between the parties.

41. The Daarasp Software had undergone subsequent development between 2004 and 2007 which obviously made it very difficult to demonstrate exactly what version of the Daarasp Software was available to anyone who wanted to undertake equity trading relying on that software in March 2004.

42. We heard evidence from seven witnesses each of whom provided slightly different evidence about what the March 2004 version of the Daarasp Software was capable of.

43. Mr Edmond said that in his role at Charterhouse, he had considered and rejected some alternative software investments for Daarasp and that he had been searching for a genuine business for Daarasp. He had relied on advice from Mr Curchod about the software which Daarasp should purchase and that the software which was purchased was proper functioning software.

44. Mr Syed Ahmed was hired by Charterhouse in 2014 to analyse the Daarasp Software but was not part of the Daarasp development team in 2004. He told us that he had not been able to retrieve the software code for the Daarasp Software as it existed in March 2004 but he had gone through all of the available versions of the software code (from 2004 until 2007), and had re-constituted the 2004 software in "*material and substantial respect*". From that analysis he had concluded that it was capable of carrying out trading transactions in 2004.

45. Mr Ahmed had used the software (having made it "FIX" compliant) to do simulated trades on the NYSE and real trades on the Karachi stock exchange in 2015 and 2016. He estimated that to make the software FIX compliant had taken 15 – 20 man days of development work.

46. He explained that the software was originally developed in the programming code language "Visual Basic" but later translated in C Sharp. The 2004 version of the Daarasp Software was not FIX compliant, but had to be made FIX compliant in order to carry out the trades on the Karachi stock exchange and NYSE.

47. Dr Castell's expert view was that the Daarasp Software had its "*essential core functions*" (the trading engine and price quote functions) in March 2004, allowing it to be used to put in bids and offers and obtain real time share prices. Dr Castell accepted that there was a gap between the core functions of the Daarasp Software which were available in March 2004 and the more sophisticated analysis and analytics which the PMID described the Daarasp Software as capable of.

48. Dr Castell told us that the version of the Daarasp Software which he was given in October 2015 included the so called CD RW#4 which was corrupted. Therefore, he asked Mr Makhdumi for other versions of the software which was still available on servers in Pakistan, which he considered to be a rigorous approach to attempting to recreate the Daarasp Software as it existed in March 2004. This was produced (and was referred to as the Castell CD). Dr Castell explained that this now had a date of March 2006, but that was because the software had been migrated from Visual Basic to C Sharp language sometime between 2004 and 2006.

49. Nevertheless, Dr Castell was confident that the work which he had done with other information which was available from the Pakistan servers showed that the Daarasp Software was functional in March 2004. He said that he had carried out "real time buy and sell trades on the Karachi stock exchange" and referred to a screen shot of an on-line trading system which was produced (dated January 2004 with the ID of Dr Shaheen) demonstrating that this was an automatic trading system which was connected to live price quotes and would have had this functionality in March 2004. Dr Castell could not comment on whether the IP addresses in that screen shot were private addresses, suggesting that the trades being undertaken were dummy test trades rather than live market trades.

50. Dr Castell pointed out that HMRC's expert, Mr Sykes had only reviewed the "static" code which was available on the copy of the CD which had been given to him and that the software would clearly not work if there was no FIX connectivity.

51. Dr Castell was adamant that the Castell CD represented substantially and materially the actual functionality of the March 2004 version of the Daarasp Software. He stressed that whether the code could be re-produced was not the relevant question, the relevant question was whether the functionality could be identified.

52. Dr Castell referred to several technical documents (system requirement specifications) which he had seen which were contemporary supporting documents and technical information about what the March 2004 version of Daarasp Software was capable of but also said "*there is nothing in the fossil record of the software that can take us back beyond the wall of 2006*".

53. Mr Sykes said that the Daarasp CD which he had been sent by Charterhouse contained two zipped files which were not corrupted and readable. The files were dated from 1999 to 2005 and were written in Visual Basic. We were shown the contents of this CD on a live screen demonstration at the Tribunal by Mr Sykes.

54. Mr Sykes also showed us the file list provided to him by Dr Castell which purported to be the same March 2004 Daarasp Software, but which were all written in C Sharp, suggesting to Mr Sykes that this was completely different software.

55. Mr Sykes said that in his view the files on the Daarasp CD which he saw were not capable of performing anything other than basic functions in 2004, if they were capable of performing any trading functions at all. In his view any trading carried out on the NYSE could only have been in test or prototype mode in 2004.

56. Mr Curchod said that the Daarasp Software as it existed in March 2004 could only have been capable of trading on the NYSE and not on the Karachi stock exchange because the necessary regulatory agreements to allow for trading in Karachi were made after April 2004. Any NYSE trading would have been through day traders acting through brokers to access the NYSE.

57. Mr Curchod said that the prototype version of the software which he saw at a London meeting on 4 February 2004 with Dr Shaheen was based on a sophisticated mathematical model for trading but the additional elements beyond the basic trade execution system were not yet in place. In his estimate about 30% of the functionality was in place at this stage. The functionality to provide analytics and analyse behaviour patterns were not in place. He described what he saw in February 2004 as "a working system", the code of which he thought was worth between £2 million and £5 million. Mr Curchod estimated that it would take until the end of 2005 for the full system to be built.

58. Mr Lee told us that he had seen the Daarasp Software being used with what he described as "canned data" at Charterhouse's offices in London on "day one". The software was working, but there was no connectivity with the Karachi stock exchange.

59. Mr Makhdumi said that trades could be carried out in this period using connectivity from the brokers' servers. He and Mr Ahmed had loaded software on to the broker's server in Karachi so that trades could be done.

The "corrupted" CD – CD RW # 4

60. The issues with the identity of the March 2004 version of the Daarasp Software were exacerbated by the fact that the CD held by Charterhouse in escrow, (CD RW #4) which was said to contain the March 2004 version of the Daarasp Software was, according to the first Appellant's witnesses, in particular Dr Castell, corrupted.

61. This was further compounded by the fact that HMRC's expert, Mr Sykes, saw a copy of this CD (only the Appellants had access to the original), which he considered to be perfectly readable, although the number of lines of code which he said he found 16,744, and the 85,000 approximate lines of code which Dr Castell said he estimated to be on the disk taking account of the corrupted elements, were rather different.

62. When Mr Sykes was made aware (as a result of reading Dr Castell's witness statement in 2017) of the issues with the readability of the Daarasp CD provided, he requested a second copy of the CD from Charterhouse in December 2017, which was also readable.

63. We heard a number of different explanations of the "corruption" on this CD RW #4**.** Dr Castell said that there were "*numerous surface and media errors*" and that parts of the code on the CD were un-readable but said it was impossible to know how this had occurred. He said that a significant percent of the blocks of code on this CD could not be loaded.

64. Mr Ahmed had not seen the 2004 CD with the original Daarasp Software on it and did not test the "corrupted" CD for himself, but he confirmed that a corrupted CD could still be read if only part of its code was corrupted.

65. Mr Makhdumi also did not actually see the corrupted CD himself, but thought that what had been produced represented about 90% of the code which was available in 2004.

66. Mr Curchod said that the full source code from the CD which had been held at Charterhouse and which he saw from Mr Sykes was not available and that the CD which he saw (dated April 2004) was not a full copy of the source code. The CD which he saw included execution files, suggesting that it was intended for the end user traders and was not the developers' version. Mr Curchod could not be certain that this was the same disk as the CD RW# 4 referred to by Dr Castell

67. Mr Curchod told us that he offered recommendations to Charterhouse about how to set up escrow arrangements and offered expertise in reading visual basic to help read the original code. Neither of these offers was taken up.

68. Mr Sykes said that CD RW#4 could not be the CD with the 2004 version of the Daarasp software because it contained files from 2006 – 2012 and was written in a different code language (C Sharp rather than Visual Basic). He also pointed out that many of the diagnostic tools which Dr Castell had used to interrogate CD RW#4 were not tools which were appropriate for analysing the information on a CD.

69. Of all of the witnesses who we heard from, Mr Curchod appeared to us to be the most credible. He was the person with the most understanding of the information technology itself and the market for products of this type, having spent 30 years developing software systems and had a genuine interest in the exploitation of the software acquired by Daarasp (and Betex).

Findings of fact

70. *On the basis of this evidence we have concluded that the March 2004 version of the Daarasp Software at best had limited functionality and may have been able to be used for some basic equity trading transactions.*

71. *We have concluded that the Appellants have not demonstrated that any live trades were done utilising the Daarasp Software before May 2004 on either the NYSE or the Karachi stock exchange.*

72. *The Daarasp Software was at most used for a small number of live equity trades through brokers on the NYSE during the latter half of 2004.*

73. *The Tribunal concluded that it was not possible to know with any degree of certainty what coding had been developed and was included in the Daarasp Software which was licensed to Daarasp in March 2004 by reference to the CDs which were reviewed by the two experts.*

The trading question

Whether the Appellants carried on a trade

What activities were actually carried out in Daarasp's 17 February 2004 to 5 April 2004 accounting period?

74. Daarasp's first accounting period was rather short; from 17 February 2004 until 5 April 2004.

75. Mr Edmond said that the opening date for investments in the Daarasp LLP was 29 February 2004 and the closing date was 19 March 2004; the period was short because the investments needed to be made before the end of the tax year.

76. Mr Edmond confirmed the figures from Daarasp's audited accounts for the short accounting period from 17 February 2004 to 5 April 2004; income of £3,619 arising from a payment from the entity called 1Ecomnet.

77. Mr Syed Ahmed said that he had been shown details of trades which were executed in 2004 through a broker in Pakistan, Mr Idress Adam, on the Karachi stock exchange.

78. Mr Makhdumi told us that he had trading receipts from trades carried out using the Daarasp Software on the Karachi stock exchange in April 2004 and from trades on the NYSE. He said that trades had been carried out in June and July 2004. It had been possible to carry out these trades through a broker in Pakistan by coming to temporary special arrangements, despite Daarasp not having the correct permissions to trade on the Karachi stock exchange at that time.

79. The document which Mr Makhdumi produced of these NYSE trades was a computer printout of a list of clients and trades and dates from 11 May 2004 to 9 November 2004 which he said had been provided by Dr Shaheen Ahmad in New York but which had nothing on it to identify the trades as being done with the Daarasp Software.

80. Mr Makhdumi also referred to an invoice dated 31 March 2004 for a fee of $6,748 payable to Parjun Enterprises on behalf of Daarasp LLP by 1Ecomnet.com "for work performed to date".

81. Mr Curchod explained that live trades had been done on the NYSE by day traders using the Daarasp Software but this was while the software was in the prototype "beta test" stage with the execution function turned off.

82. He confirmed that he understood that in 2004 some actual trading was carried out on the NYSE using Daarasp Software, although he had not seen any direct evidence of this.

83. Mr Hargreaves told us that he was aware of the income which had been generated in 2004 for Daarasp from deals in New York and Karachi, although he did not see any underlying deal documentation and was keen to understand how the software was being exploited. He referred to the statements made by Mr Makhdumi that the software for trading on the Karachi stock exchange was "virtually complete" in September 2004.

84. Mr Lee said that when he saw the Daarasp Software it was the first software which he had seen which gave direct execution ability for equity trading. He understood that in March 2004 the software was working but there was a connectivity issue, which was why trading had to be done through an authorised broker in Pakistan. He had seen the software working with "canned data".

85. Mr Lee described the Daarasp Software in 2004 as "*easy to use, it was quick, it was user friendly and it was intuitive..... it was the nearest thing to futures trading software which is – as it was five years ahead of all equities software*".

86. In contrast, Mr Sykes described the Daarasp Software which he saw as not capable of undertaking trading transactions in 2004 or 2005, describing it as an "empty shell**".** He said there seemed to be confusion between test trades and actual trades and that there was no design or marketing documentation to support the exploitation of the version of the Daarasp Software which he saw**.**

Findings of fact

87. *We have concluded that the Appellants have not demonstrated that the Daarasp Software could be used for live transaction, or that any live equity transactions were undertaken using the Daarasp Software, during the accounting period (from 17 February 2004 to 5 April 2004) in which Daarasp acquired the Daarasp Software licence.*

88. *Daarasp did not have permission to deal directly on either the NYSE or the Karachi stock exchange at this time and all deals had to be done through brokers who were members of those exchanges.*

89. *As evidenced by its accounts, Daarasp generated a small amount of fee income from 1Ecomnet.com (via Parjun Enterprises) but it is not clear what activities those fees related to. The invoice which we saw between 1Ecomnet and Parjun Enterprises dated 31 March 2004 in respect of these fees did not refer to equity trading.*

What activities were carried out in later accounting periods?

90. Mr Edmond confirmed the accounting figures for Daarasp's 2004-5 accounting period showing that the majority of its income £805,650, came from payments made under the Warranty Payments with only £9,433 derived from trading income. The trading income payments were from Parjun Enterprises in Pakistan (the trading name of Mr Makhdumi's business) and 1Ecomnet in the US, both of whom were distributors for Daarasp.

91. Mr Edmond accepted that the partners in Daarasp had never been paid out any profits and that Warranty Payments made to the partners by Damats were sourced from the interest income (charged at 4.75%) on the members' loans, although no bank statements had been provided to show that cash payments had been actually made to satisfy these matching obligations.

92. Mr Curchod told us that he did not seen any design documentation for the Daarasp Software and that one of the reasons for his trip to Karachi in April 2004 was to check the specifications of what was being developed. He did ask for development plans and milestones but none were provided until Mr Nisar started managing the project at the end of 2004.

93. Mr Curchod was not aware of Mr Makhdumi having developers working for him in Pakistan. The only developers who he met in Karachi when he visited in April 2004 worked for DCC. He was shown the server hosting service which allowed Daarasp to access the server capacity needed to do trades for a small number of customers, which could be increased as required.

94. Mr Curchod said that he was not aware of any direct relationship between Daarasp and a broker in Pakistan. He was aware from the Progress Report provided in December 2004 that permission had still not been obtained to trade on the Karachi stock exchange and that the development of the day trader functionality had been halted before it had been completed. He had understood that the plan for Daarasp was for it to start by generating business on the Karachi stock exchange and then move on to other middle-eastern markets, targeting wealthy expats.

95. Mr Makhdumi explained that no "milestone" documents had been produced for periods before 2005 to keep the LLP members informed of progress, but he said this was because the LLP was mainly interested in end results. As the distributor he had approached banks and brokerage houses to discuss the Daarasp Software as well as day traders. Mr Makhdumi said that in his view the quarterly reports which had been produced for the LLP were sufficient to keep Daarasp informed of what was happening.

96. In response to directions from the Tribunal, Mr Makhdumi did produce what he described as a "milestone document". This was in the form of brief bullet points extending to six pages and referring on page 1 to the "*marketing strategy (sic) and development plan*" dated January 25 2004. That page referred to "*Development of proprietary trading and internet based online retail market access*". Page 2 included "*what's done to date" as: initial set of test customers; marketing to trading funds; development of a trading floor for location of a trading fund; marketing to potential partner with license(sic) to the Karachi stock exchange*"

97. Mr Hargreaves said that no Daarasp member meetings were held until September 2004 because it was hard to get all of the relevant people together and that he did encourage all LLP members or their intermediaries (their financial advisers) to attend. He accepted that only one distributor was present at the LLP's September 2004 meeting.

98. Mr Hargreaves told us about the meetings of the LLP members which happened in September 2004 and February 2005, saying that the members were actively involved in these meetings, referring in particular to Darren Lee and a Peter Coy who were genuinely interested and had the expertise to contribute asked about marketing plans and the types of trading which were being carried out. He referred to the need to have quarterly meetings in order to "get sales back on track" and that he was sensitive to concerns about the level of turn-over being generated by the software in 2004 and 2005.

99. Members were given written notification of meetings and the LLP's annual accounts as well as periodic reports on their capital allowances claims. The first set of accounts was approved at the 6 September 2004 meeting. Mr Hargreaves could not specifically recall seeing monthly management accounts but he told us that he had asked for information about the trades which had been carried out by the LLP and that management information was provided quarterly.

100. Mr Hargreaves said that "*the LLP was profitable due to the level of warrantied income proving the robustness of the structuring*" in September 2005 and that at this stage Mr Makhdumi was pursuing three contracts which were personal contacts in Karachi.

101. Mr Hargreaves could not fully explain why a standing order had been set up in order to make the warranty payments to Daarasp, and resisted the suggestion that the expectation was that income would come from these payments rather than profits earned from the software itself.

Findings of fact

102. *The evidence which we saw and heard about Daarasp's activities from 6 April 2004 until 5 April 2005 suggested to us that Daarasp's only real source of profit was the warranty payments and that its exploitation of the Daarasp Software licence for on-line equity transaction activities was minimal.*

103. *During this period few actions were taken by any of those involved with Daarasp to ensure that its business was on track to generate the profits which had been predicted in the PMID.*

104. *Daarasp did not have a framework or resources to support significant trading activities and no oversight of the activities which it outsourced to others.*

Why were no profits ultimately generated?

105. We were provided with a number of different explanations for why Daarasp failed to generate any profits, ranging from external market forces to internal failures:

106. Mr Edmond's explanation for the failure of Daarasp to meet its targeted income in year one was that it had proved harder to access the Karachi stock exchange than expected. He said that despite Daarasp's disappointing early results, he had not revised his projections for the LLP and no consideration had been given to changing distributors or acquiring any other software, while stressing that decisions of this kind were outside his remit.

107. Mr Makhdumi said that the reason for the failure to make profits from the Daarasp Software was the Karachi stock exchange crash in 2005-6, (due to an insider trading scam) and the meltdown in the international markets in 2007-8, which put a monkey wrench in Daarasp's plans for the Pakistan market and meant that all development effort was curtailed at the end of 2007. He said that he had not reduced the LLP's profit predictions for later periods despite its lack of profits in 2005, in his views those predictions were merely "a little optimistic".

108. Mr Hargreaves insisted that there was a real expectation of profit at the time when the contracts were entered into in 2004. Mr Hargreaves' conclusion was that profits were not generated by Daarasp because not enough energy had been put into its distribution or the building of real trades.

109. It was his view initially that the software would either generate profits quickly, or not at all. He relied on Mr Curchod and Mr Edmond for information about the profits being generated and their source. After Daarasp's first three years Mr Hargreaves was more circumspect about its prospects, particularly taking account of the economic conditions compared with 2004.

110. It was correct that Daarasp did not have a business plan, but one was not required since all parties, including the distributors, had an economic incentive to encourage sales. The LLP members did consider and discuss changing distributors because of the income from the software being so poor, in early 2008.

111. Mr Hargreaves pointed out that he visited Pakistan in 2006 to make sure that the right things were being done and said that he had emailed and telephoned the distributors for information about their activities, although we did not see any evidence to support this.

112. Mr Hargreaves could not explain why there was no clear obligation in the Warranty Agreement with Mr Makhdumi to continue to develop the software, but did point out that Mr Makhdumi's development obligations had been set out in meeting minutes.

113. Mr Makhdumi said that he had spoken to some of the Daarasp members when the LLP failed to meet its initial profit expectations, including Darren Lee, who made constructive suggestions. In the event he undertook further development of the system himself. Mr Makhdumi said that he did have a copy of the development document which was produced for the Daarasp Software, although Daarasp was really only interested in end results. He said that Daarasp had expressed disappointment about the income generated by him as a distributor but had never suggested terminating the distribution agreement.

114. Mr Curchod told us that he understood that no further development of the Daarasp Software was undertaken due to budget constraints within the development company.

Findings of fact

115. *The explanations which we were given for Daarasp's failure to generate income were inconsistent and in our view demonstrated that there was no coherent and businesslike approach from anyone involved in Daarasp to ensure that the Daarasp Software licence was properly exploited to earn profits, either during the relevant accounting period or any later periods.*

Marketing and business management – who was the directing mind of the LLP?

116. Mr Edmond said that while he worked with advisers on the documents for the transaction and was a signatory on the Daarasp bank account, he had no formal role in the LLP and was not involved in the selection of the software for investment, which was done by Michael Sherry and Mr Curchod. He had been introduced to Mr Makhdumi through his brother in law, Mr Siddiqui, who worked at Charterhouse. He was involved in reviewing the marketing material and the PMID and had discussions with potential investors but did not make any formal presentations about Daarasp's business.

117. Mr Edmond said that the business of the LLP was outsourced to those who had the relevant knowledge, particularly Mr Curchod and the other distributors. Oversight of the LLP was managed through meetings and reports back. The LLP did not have employees who could undertake its business. The distributors undertook the exploitation, marketing and implementation of the LLP's trading strategy.

118. Mr Edmond visited Pakistan, met Mr Makhdumi and went to the DCC offices. He confirmed that DCC was 40% owned by Mr Makhdumi. Mr Makhdumi himself was

the Pakistan distributor for the Daarasp Software, but was not himself the person who provided technical expertise (this was provided by Mr Nisar and his team of 30 developers in Pakistan and Mr Ahmed), or the person who did the profit projections for the Daarasp Software.

119. Mr Makhdumi explained that he viewed his role as marketing and distributing the software, demonstrating in particular its speed. In his view Daarasp's main market was the day trader market, unlike their larger competitors who were looking at larger customers. Mr Makhdumi had seen similar products, including TPZWeb and Market XT and had seen the "proof of concept" for the Daarasp Software.

120. Like Mr Edmond, Mr Makhdumi described all of the day to day activities of Daarasp as outsourced, with Daarasp only interested in end results.

121. Mr Hargreaves was the managing partner of Daarasp. He described his role as acting on behalf of all members of the LLP to make sure that the arrangements were carried out, that the cash flows and that contract flows happened and the partners got what they expected. He was also an investor in Daarasp. Mr Hargreaves was not an expert in IT software and made clear that he relied on others, mainly Mr Curchod, for this aspect of the arrangements.

122. Mr Curchod was not an investor in Daarasp, but saw his role as a "software auditor" who was employed to make sure the partnership did not lose money. He had early discussions with Mr Sherry and undertook a role with Pie 3 to identify software which could be put into partnership structures to obtain tax relief.

123. Mr Curchod visited Karachi in April 2004, visiting Parjun Enterprises and DCC, he also visited the Karachi stock exchange to discuss arranging for price feed arrangements to be put in place. He confirmed that DCC had about 50 employees including 40 programmers. He did not identify any programmers working for Parjun Enterprises**.**

124. Mr Curchod explained that the original plan was for Parjun Enterprises to become a broker and trade on the Karachi stock exchange, but it was eventually decided to trade using an existing broker.

125. He was also, for a brief three month period, the London distributor for the Daarasp Software. His distributor agreement was not extended because he needed to be able to sell a trading desk functionality in London and this had not yet been built by Daarasp. He also expressed the view that Mr Makhdumi wanted to keep him at a distance because he asked difficult questions and challenged some of Mr Makhdumi's decisions.

126. Mr Curchod thought that the most obvious market for the Daarasp Software was the hedge fund market. Mr Curchod wanted to acquire an interest in Mr Makhdumi's Pakistan business because he was convinced that it could make profits. He did not invest in the Daarasp partnership, but did invest in its related partnership (Faardar).

127. Mr Curchod told us that by the September 2004 meeting of the Daarasp LLP he was concerned about who was steering the project forward and that the developers in

Pakistan were becoming distracted by trying to develop functionality (e.g. for derivative trading) which was not part of the original plan. He thought that there should have been a plan for stage payments as the development progressed and agreed that in fact the Daarasp LLP had no enforceable rights to ensure that the development of the software was carried out as required. In his view the business plan for Daarasp was not sufficiently detailed and was "a bit confused" about what was actually being provided.

128. Mr Curchod said that he was aware that the marketing of the Daarasp Software was essential if it was to be successful and he was concerned that there was insufficient detail about the Daarasp Software in the material which he saw. He was also concerned that no website was developed for the marketing of the software and no-one in the Daarasp LLP was involved in the marketing of the product.

129. Mr Curchod told us that no-one in the Daarasp LLP took any initiative to question the development which was being undertaken and neither did anyone ask him to try and take up any issues with the developers in Pakistan or the US. It was only when Mr Nisar started managing the project at the end of 2004 that proper progress reports were received.

Findings of fact

130. *It is not clear to us who was actually responsible for making business decisions on behalf of Daarasp and who, if anyone, was providing a business plan.*

131. *In the Tribunal's view, the only person with an extensive understanding of Daarasp's business was Mr Curchod. He was not directly involved with Daarasp and seemed to feel that he had intentionally been kept away from the business by Mr Makhdumi when he asked difficult questions. Those who were more directly involved absolved themselves from responsibility for making significant business decisions. With the exception of Mr Lee, none of the Daarasp LLP members took any active role in the management of its business either.*

Expenditure incurred

Whether expenditure was incurred and if so, what was the expenditure incurred on, the software licence or something else?

The valuation of the Daarasp Software licence

132. The PMID on which the Daarasp members relied for making their investments valued the Daarasp Software licence at £28 million in March 2004. We heard from those who were involved in establishing that valuation.

133. Mr Edmond produced the PMID which included the valuation of the Daarasp Software licence. Mr Edmond said that the figures which were produced for the PMID were "done on the back of an envelope at the time". Mr Edmond described his valuation as "*a genuine valuation based on the information provided*" but accepted that his

valuation had not been scrutinised by any independent source and that he did not have help from anyone who had any expertise in valuing software.

134. Mr Edmond accepted that he was not an expert in valuing software and explained that his valuation of the Daarasp Software licence was derived from the profit projections in the TSZ Web Document, (which related to an earlier version of the Daarasp Software) which he thought were reasonable and to which he applied a conservative approach, adjusting those figures downwards and applying a 5% per year growth assumption based on his experience of valuing other types of business.

135. The projections did not take account of potential different clients for the software (day traders, investment banks or private investors) his view being that the most significant indicator of profits was the number of trades per customer.

136. His valuation was based on a worldwide software licence worth £28 million, not a licence which did not include the Australasian markets. He could not recall exactly how the £26 million valuation for the option granted to Parjun Enterprises had been arrived at but said "*it was to be a big enough figure to make it worthwhile to the members and cover everything that had been spent and give them a return"*.

137. His valuations did not look at a range of projections (low, medium, high), but he did expect the business to take off and be profitable very quickly. Mr Edmond could not explain why he had estimated that the business would obtain over 5,000 customers in year one.

138. Mr Edmond said that Mr Makhdumi had insisted on a buy-back option so that he could buy back the software licence if it was successful, although it had been priced on the basis of his minimum profit projections. He explained that if Mr Makhdumi had exercised his option rights, the returns to investors would have been much higher than his projections, although he could not recall how the option pricing had been agreed.

139. In March 2004 Mr Makhdumi had two years' experience of software trading apps and had looked at buying a company with activities similar to Daarasp, Market XT. In his view the value of the Daarasp Software was bound to increase over time. At the time of its launch the numbers of clients involved in day trading was astronomical. He said that the Daarasp Software was better than Market XT, despite Daarasp's customer predictions being more conservative. His intention was that Daarasp would break into the market by giving price discounts and by aiming for medium sized customers. Customers would be acquired by targeting brokers. The Daarasp Software was newer and more cost effective than its competitors.

140. Mr Makhdumi said that the main market for the Daarasp Software was the day trader market "smaller, mid-level customers". In comparison with other similar products (for example Ninja Trader) Daarasp was intending to provide a better long term relationship with customers, who would pay per trade depending on the number of shares traded.

141. Mr Makhdumi said that he needed the option agreement so that if the software was as profitable as it was projected to be, he could have access to it himself. It the

software was successful, he wanted to be able to sell it on to someone else to make money. The only reason why he had not exercised the option was the 2008 financial crisis.

142. The decision to give the software licence a 25 year term was a shared idea and was intended to provide the opportunity of on-selling the licence.

143. Mr Ahmed said that the type of software owned by Daarasp had good potential and that the figures provided by Mr Edmond were reasonable projections by reference to similar start-ups he was aware of in Pakistan in 2004 and to brokerage houses which he was aware of who obtained similar numbers of customers. In his view Mr Edmond's numbers and methods "responded to the relevant market", including different commission structures. The projected figures were achievable if the software was properly marketed and introduced, given what he knew about daily trading on international exchanges.

144. Mr Curchod, who had many years' experience of building IT systems and estimating project costs, though not of valuing software, suggested that the projected profits arising from the exploitation of the Daarasp Software could come from three main sources; day traders (for which the software was suitable in March 2004), trading desks in investment banks and hedge funds.

145. Mr Curchod commented on Mr Edmond's profit projections, saying that in his view the price per trade and number of customers was low, compared to the way he had seen other similar businesses expand. Mr Curchod said that Mr Edmond did not have access to estimates done by Mr Curchod, but that if he had, his estimated profit figures would have been higher. Mr Curchod estimated that the costs of developing the Daarasp Software were between £4 million and £17 million.

146. Mr Curchod's view of the Daarasp Software was that it provided something better than anything else in the market; it provided better execution and cheaper costs of dealings, it had a better user interface (providing an integrated system through its front screen) and was able to look at strategy and trends of the user as well as providing a training programme. Mr Curchod was clear that this had value as an "idea" and that, while the Daarasp Software would get more valuable as it went through its development stages, as long as the foundations were built and provided fast processing, the other elements could be added.

147. Mr Curchod explained that the costs of a developer (on a man day basis) and how many lines of code could be produced per man day depended on the language being used. A developer writing in a sophisticated language such as C Sharp may only be able to produce 10 lines of code a day, whereas someone writing in Visual Basic may be able to produce much more.

148. Dr Castell said that he had experience of valuing a few software licences and a valuation of the Daarasp Software between £20m and £30m was a fair estimate of the value of the Daarasp Software licence in March 2004 taking account of reasonable steps which were to be taken to market and develop the software. He agreed with the

assumptions made in Mr Edmond's valuation while accepting that there was no industry consensus about how software like this should be valued. He had not interrogated Mr Edmond's numbers but had accepted that they produced a reasonable range for the valuation.

149. Dr Castell explained the different ways of valuing software, taking account of the number of man days to develop code, which he estimated as 10 lines of developed code per person per day, with costs of development differing depending where coders were; costs were lower per man day in Pakistan than New York. His valuation had assumed a 50/50 split between New York and Pakistan for the Daarasp Software developers. He had then applied a 10 times multiplier to the assumed costs. That multiplier was on the basis of his experience in the market and was in his view conservative.

150. Dr Castell referred to Daarasp's competitors, some of whose profits had increased by 25% year on year, suggesting that Mr Edmond's estimates were conservative saying "*the numbers put into the project plans were tiny, tiny market penetrations compared with what was going on in the market at the time*" Dr Castell cast doubt on Ninja Trader as a real competitor in Daarasp's market place.

151. Mr Ahmed said that the Daarasp profit predictions were done by Mr Nisar. Mr Makhdumi said that Mr Nisar was in charge of the technical work, the profit predictions had actually been done by him with Dr Shaheen Ahmad, who had been involved with Market XT.

152. Mr Hargreaves said that he had no part in the assessment of the valuation of the software licence, but that he thought that the projections provided by Mr Edmond were credible. He did not test the valuations provided by others, since it was not his area of expertise. His belief was that much of the profitability depended on the volume and bulk of transactions and that the business would work by building up a large number of clients quite quickly.

153. He did say that the numbers which were produced just before the transaction was signed on 26 March 2004 were "rough and ready" because of the time pressure to get the deal done and that it was driven by the £1.4 million which Mr Makhdumi said he required.

154. Mr Lee told us that the Daarasp Software was the first software which he had seen which gave day traders direct execution on the market (i.e. the completion of equity traders with no human intervention) and he was interested in using the software for his own equity trading business.

155. Mr Sykes explained that a method for valuing the Daarasp Software licence based on a discounted cash flow approach was not appropriate for software which was not complete; lines of code analysis was a better method for incomplete software. He described the Daarasp Software as "an empty shell". He thought that he and Dr Castell's conclusions about the number of lines of code which had been generated were not miles apart, but did differ in the average costs of a programmer. Mr Sykes said that a New

Zealand programmer would be paid 50% of a US programmer and a Pakistani programmer only 25%.

156. Mr Sykes also said that in his view, because of the rapidly changing nature of the IT industry, no-one would buy a software licence for as long as 25 years, and certainly not without clear obligations on the seller to support and update it.

The carve out of the Australasian rights

157. According to Mr Hargreaves, the LLP members were not formally notified in March 2004 that the software licence in which they would be investing would have a value of only £18 million because the Australasian distribution rights had been excluded. He did suggest that some informal discussions about this may have occurred and described the allocation of value as "*rough and ready. After all, the offer was meant to close the next day*".

158. Mr Makhdumi suggested that the Australasian valuation had been done by reference to the levels of activity in the US, EU and Australasian markets based on his experience of on-line trading. He described the methodology as scientific although not a "*very very sophisticated guess*". He also referred to published articles from 2006 and 2016 which he said supported this split by reference to Australasia having 18% of the world equity trading market.

159. Mr Edmond said that the figure which had been ascribed to the Australasian element of the licence valuation had been done by reference to a "geographical split" but explained that for investors the return would be the same whatever price was paid for the software licence because their return was calculated by reference to what had been invested.

Findings of fact

160. *Our conclusion having heard extensive evidence about the basis on which the Daarasp Software licence was valued, including the manner in which the rights to the Australasian market were carved out, is that while many of those involved believed that the software was valuable and novel, none of those who were involved in the valuation process were experts in valuing software of this type and relied on other sources as the starting point for the valuation. The valuation was described by those who were involved as "rough and ready". Despite this, no third party assessment of the valuation of the Daarasp Software licence was carried out.*

The object of the expenditure – the anti-avoidance rule in s 215 CAA 2001

161. Mr Edmond accepted that his early involvement in the transaction and discussions with Mr Michael Sherry in 2003 had included considering the availability of capital allowances for investment in software.

162. Mr Edmond said that a DOTAS form had been submitted for Daarasp type transactions as a matter of caution in December 2004; the DOTAS legislation was new and everyone was erring on the side of caution about what transactions needed to be notified to HMRC.

163. By reference to the extensive details about the availability of losses included in the PMID Mr Edmond explained that that level of detail was required because the tax rules were complex.

164. Mr Curchod told us that the idea for the Daarasp structure came from Mr Sherry who had been introduced to it by Mr Siddiqui at Charterhouse.

165. Mr Hargreaves said that at the time when the LLP arrangements were entered into there was "*every hope, wish, that there would be commercially successful operation of the software*" and that capital allowances were available for investments like this because the government recognised that they needed to encourage investment and that there would be many failures and some successes. In his view, trying to maximise the tax loss relief while also maximising the LLP's commercial success was perfectly legitimate and normal.

166. Mr Makhdumi said that he only needed £1.4 million as mezzanine financing to enable the next stage of development work to be done on the software. No further funds were ever obtained because of the problems with the Karachi stock exchange.

Findings of fact

167. *The availability of capital allowances was a major factor for those at Charterhouse who implemented the Daarasp structure and for the members who invested in it.*

The financing arrangements – the warranties, the loans from Hambros and the Secondary Loans

168. Mr Edmond could not explain why Hambros had only asked for profit projections for three years despite the 25 year term of the Software licence. Mr Hargreaves was the person who had chosen Hambros as the lending bank.

169. Mr Edmond accepted that, by reference to its accounts, Daarasp was only profitable because of the warranty income which it received.

170. Mr Hargreaves accepted there were no profit distributions to members and that interest paid by the members on their loans from Hambros UK was generated from interest on the Hambro's Jersey deposits which was intended to be a matched amount; payments on the Secondary Loans made to LLP members would be met out of the warranty payments, being equal and opposite payments. There would be a warranty payment made from Damats to the LLP and then a payment to the LLP of the profits

due in settlement of their interest liabilities under the Secondary Loans. These payments were all managed internally through Hambros accounts.

171. Mr Hargreaves explained that after the end of the Secondary Loan Period, a second warranty would be triggered, which was equal and opposite to the sum of the Secondary Loans. He viewed this as a fall-back position. Mr Hargreaves did not accept that the loans made to LLP members were effectively non-recourse (despite the letter of 12 March 2004 setting out the basis on which the loans would be repayable through a counterclaim and referring to the very small risk of investors having to make any loan repayments).

172. Mr Hargreaves also explained that although Mr Curchod was not a direct investor in Daarasp, through his interest in Pie 3 he did have an investment in the general partner of Daarasp, Piedama, giving him effectively a long term carried interest return.

173. Dr Castell said that in his view warranty payments were a reasonable component of the deal and upfront payments for software were a "perfectly understandable arrangement" but also said that he had no direct experience of the sale of companies and the giving of warranties.

174. Mr Curchod said that paying a sum in advance and the remainder in stage payments was normal business practice for IT contracts**.**

Findings of fact

175. *Looking at the financing structure as a whole, the members' loans were limited recourse, in substance if not in form. The warranty payments removed any risk that the members would not obtain at least an interest rate return on their investments, even if the Daarasp Software licence did not generate any profits.*

176. *The ultimate seller of the Daarasp Software, Parjun Enterprises, only received £1.4 million for the sale of the licence on day one. The remaining payments were contingent on the Daarasp Software being profitably exploited by Daarasp.*

The ownership of the software

177. Mr Edmond said that a warranty had been obtained from Mr Makhdumi and Dr Shaheen Ahmad to make it clear that they owned the software which was the subject of the licence. This agreement had been reviewed by solicitors and Mr Edmond thought it was fit for purpose.

The role of Damats

178. Mr Makhdumi explained that Damats had been included in the structure as a result of Hambros not wanting to deal with an unincorporated association.

BETEX

Betex evidence

179. The evidence which we heard concerning Betex and its transactions included some witnesses who were involved in both LLPs, Mr Hargreaves and Mr Edmond had similar roles in Betex as in Daarasp.

180. It was accepted by the parties that Betex was a similar transaction to the Daarasp transaction and had been generated from the same source, Mr Sherry and the Pie 3 partnership.

181. Unlike in the Daarasp case, the parties accepted that the on-line betting software licence which was acquired by Betex existed and was capable of undertaking transactions at the time when the partners made their investments in Betex. Unlike the Daarasp transaction, those investments were made in two stages, the first in November 2005 and the second in March 2006. No explanation was provided by any of the witnesses for this.

182. The funding of Betex also differed in some details from the funding of Daarasp, particularly a percentage of the loans made to Betex (60%) came directly from Hambros London (rather than through the investing members). All financing provided to Betex was made via an intermediary nominee entity, Redbar.

Documentary evidence

183. **Transaction documents to which the Tribunal was referred**

(1) Betex Partnership Agreement dated 4 November 2005 between Peter William Hargreaves (Managing Member) and Alan Dart (General Member).

The business of the LLP is described at paragraph 2 as "*the acquisition, development and exploitation of Software by providing data processing services (and cognate services) using Software".* The target capital of the LLP is stated to be £26,000,000.

Details of the Secondary Loans are included at clause 7 – Profits and Losses including at 7.5.2 "*until the Secondary Loans have been repaid, an amount of profit equal to the interest on the Secondary Loans will be paid to the Secondary Loan Provider on behalf of the Members entitled to such profits to settle their interest payments*".

Clause 17 deals with the winding up of the LLP stating that "*the Software shall belong to the General Member subject to and charged with any remaining liabilities not discharged".*

(2) Betex Deed of Adherence dated 4 November 2005, setting out the names of the members wishing to join the Betex LLP

(3) Prospective Member Information Document (PMID) setting out the Betex LLP structure including a description of the Betex Software capabilities "*The IGS Bet Exchange system is centred on a betting exchange engine that caters specifically for person to person exchange betting. It can be extended to support virtually any type of betting due to the modularity of its design*" and "*The new version of the IGS Bet Exchange.NET application has been recently completed*". On the management of the LLP it is explained that "*Whilst the management of the business will be under the overall control of the Managing Partner, management and supervision of the following areas will be delegated by the LLP to suitably qualified persons: checking software development; lodging the source software with an appropriate custodian; agreement of marketing plans; supervision of sales agents; verification of income; accounts and record keeping"*

Unlike the PMID for Daarasp there is no reference to meetings of members.

The acquisition cost of the Software is stated as £64,806,700 million payable in full at the time of acquisition.

This is followed by a description of the potential returns which refers to the expected 40% capital allowances and the Secondary Loan arrangements.

(4) Discounted cash flow valuation –Betex LLP "Income expenditure and cash flows" on a discounted cash flow over a 15 year term. (Appendix to PMID)

(5) Deed of Agreement dated 4 November 2005 between Betex and Piebet.

This records at Schedule 5 the receipt of the Initial Consideration of £58,427,395 and refers to the Consideration of £64,806,700 and the Further Consideration but makes no reference to how the "Further Consideration" of £6,379,306 is to be paid.

It records a brief description of the Software at Schedule 3 "*The OGS Bet Exchange software product is an enterprise scalable Microssoft.NET system developed by Hewlett Packard exclusively for Ecoholdings Media Group (EMG) Limited. The source code and intellectual property rights are wholly owned by the Grantor. The IGS Bet Exchange System has been designed to be operated on the internet using the Microsoft suite of products....."*

(6) The Grantor's warranty obligations are set out at Schedule 4.

(7) Deed of Agreement between EMG and Piebet dated 4 November 2005

This records EMG selling all of its rights and interest in the Software to Piebet. Schedule 2 sets out the consideration payments, referring to the payment of the Initial Consideration and the Further Initial Consideration. The Balance of the Consideration is stated to be payable in instalments subject to interest at 3.75%.

Schedule 2 states that Piebet anticipates granting a licence of the Software to Betex and provides details of how it will deal with the consideration which it receives from Betex, including placing the funds with Hambros, the security agreements, the obligation to pay the Secondary Loans out of those funds in two

years time, the obligation to pay warranty payments to Betex and also an obligation to re-pay the Balance of the Consideration out of any surplus funds ("Purchaser's Free Funds").

(8) Distributor Agreement between Betex and IGS dated 4 November 2005 appointing IGS as Betex's distributor of its data processing services

"*to enable online person to person betting exchanges by users in jurisdictions where betting exchanges are legal using the Software*" and to *"provide such services in conjunction with the Distributor to the Distributor's ultimate customers and to route the service as required by the Distributor on hardware provided by the Distributor*".

The agreement sets out the fees payable per transaction and has a minimum term of 36 months for "*those countries in which Betex is licenced to exploit the software*".

(9) Squirrel Trust Settlement dated 29 September 2005 between Peter William Hargreaves and Bedell Trustees Limited.

The purpose of this trust is stated to be the facilitation of the acquisition of the Betex Software. Mr Hargreaves is the settler of the trust and its original trustee is Bedell Trustees. The beneficiaries of the trust are not specified. The purpose of the trust can be stated as achieved or terminated by the managing member of Betex.

(10) Option Agreement dated 18 June 2005 under which Piebet is granted an option by EMG for a premium of £1 to acquire the Betex software in consideration of the payment of £65 million including Initial Consideration of £1,820,000.

(11) Option Agreement dated 4 November 2005 between Betex and EMG under which Betex agrees to grant EMG an option to acquire the Licence at any time between 1 November 2006 and 31 October 2010 by notifying Betex of its intention to do so and paying the exercise price of (1) £77,500,000 if the territory covered by the Licence is the World and (2) 69,000,000 if the territory covered by the Licence is the World excluding Africa and South America.

(12) Support Agreement dated 4 November 2005 between Betex and IGS New Zealand under which IGS agrees to provide technical support for the Betex Software for a minimum period of three years. The agreement covers all of the "*countries in which Betex is licensed to exploit the Software*".

(13) Operator Agreement dated 10 January 2006 between Bedell Trust UK Limited, Betex and Charterhouse appointing Bedell Trust to act as Operator of the Betex LLP.

(14) Operator Agreement dated 10 January 2006 between Triple Point Investment Management Limited, Betex and Charterhouse appointing Triple Point to act as operator of Betex LLP.

184. **Ancillary documents**

(1) Accounts of Betex for the periods ended 5 April 2006 and 5 April 2007. The accounts for the period to 5 April 2006 show operating profit of £628,367 with interest and other charges payable of £731,635, generating an overall loss of £101,977. Turnover shows sales of £5.00 with other income of £1,193,591, being warranty income.

(2) The accounts for the period to 5 April 2007 show an operating profit of £1,772,157 and an overall loss of £178,864. Turnover shows sales of £967 and warranty income received from Piebet[1] of £3,015,350.

(3) Betex bank statements from SG Hambros bank account for the periods 3 November 2005 – 20 April 2006 and 20 April 2006 to 31 March 2007.

(4) Valuation report from Valuation Consulting Limited dated December 2005 valuing the Betex Software at between £60 million and £75 million.

(5) Vantis correspondence dated 1 February 2005 commenting on the IGS business plan of 17 December 2004.

(6) MECN report dated March 2004 "Betting exchanges – The eBay of the betting industry. A new era of betting in Europe".

This is an over view of the betting exchange industry, pointing out that "person to person" betting has revolutionized sport betting in the UK but is almost completely unknown elsewhere and advising readers how to prepare for the start of betting exchanges in other markets.

Their focus is on the European (not the US or Asian markets) and they recognise that Betfair has already revolutionised the UK market. The report deals only briefly with those who provide the software to the betting exchanges, but does refer to two existing providers of such software.

In its predictions of market growth the report says "*The result of this development will be a market where a few players dominate and new entrants will have a rather difficult time. Betfair has a market share of about 80% and its closest rivals.... together have about 15 -18% market share, which leaves only a marginal rest for all other exchanges"*.

Although the report does not consider the US market, it does point to the regulatory issues which are already becoming clear from the European court decisions and their advice is to consult local law and lobbying experts and be prepared for difficult and lengthy legislative deliberations.

(7) Strategy Documents and business plan - Interactive Gaming Systems Limited – IGS Bet Exchange Business Plan October 2004 prepared by Robert Earle and Interactive Gaming Systems strategy document [undated] prepared by Robert Earle.

[1] The warranty workings included with the accounts refer to Damats – but presumably this is in error.

(8) Email of 4 November 2005 from Valuation Consulting to Peter Ramsey (Charterhouse) headed "Indicative valuation opinion – revision due to client request" and stating:

"*Based primarily on DCF model that assesses tax on the revised cash flows you provided on 28 October and our research we value the Betex betting exchange software at up to £66 million"* and *"In particular our report would refine our opinion, providing a narrower range or indicating the region of value in a manner suitable for your purposes including detailed information*"

185. **Notes of Betex LLP member meetings**

(1) Minutes of meeting of 9 May 2006, including

(a) PowerPoint presentation at which the sales agent is recording as saying "*it was difficult to compete with the large players in terms of publicity spend, but by targeting price sensitive punters and providing a wide platform of related services, they were optimistic about carving out a niche position*".

(b) The Betex management accounts for 2006. The Betex Progress Report for period ended 5 April 2006 referring to the marketing campaign gaining momentum and a marketing strategy being formalised for far eastern markets and "white label" partnerships with two other entities, one in Cyprus and one in the UK.

(c) A news item (using the trading/brand name "fubet") saying "*fubet.com will specialise on a number of key sporting events around the world. Fubet.com is not available to US residents at this stage due to the restrictive online gaming laws in the US*".

(d) A "soft launch" for IGS using the Betex Software is described for March 2006 with a full launch in May 2006. Fubet's revenue in the 2nd month of trading is described as "modest" amounting to £423.37

(2) Minutes of a meeting of 1 December 2006 referring to

(a) A further PowerPoint presentation setting out IGS' strategy as Distributor for Betex, mainly looking at new distribution channels including appointing an agent for the Asian market and cutting commission rates.

(b) Reference is also made to the September 2006 US Gambling Bill which "*had a seriously adverse effect on the online gambling sector including businesses such as IGS and Betex"*.

(3) Minutes of a meeting of 7 July 2007 including a PowerPoint presentation by IGS stating that Betex commission from March 2006 to June 2007 amounted to

£1,230.00 and that next steps included a fund raising exercise and the possibility of sub-licensing the fubet exchange and including the statement that:

> *"The long term aim is to build up sufficient market share so that Betex/IGS become a thorn in the side of Betfair which would buy them out"* and *"In summary, the actual income to date for Betex remains low, but IGS through Betex has a working and sophisticated system and is trying a range of approaches to build up market share*"

186. **Financing documents**

(1) Nominee Agreement between the "Principals" (members of Betex LLP) and Redbar dated 4 November 2005 under which Redbar agrees to act as nominee on behalf of the Betex LLP members to borrow up to £20,150,000 from SG Hambros Bank & Trust Limited and pay that sum to Betex in satisfaction of the members' capital contributions.

(2) Loan facility offer from Hambros London to Betex dated 4 November 2005 in the amount of £39,000,000 for a period of two years and three months subject to the receipt of a guarantee from Hambros CI for the full amount of the loan.

(3) Guarantee Agreement from Hambros CI dated 4 November 2005 to Piebet agreeing to guarantee the obligations of Redbar and Betex under facility letters entered into by those entities with Hambros London for £20,150,000 and £39,000,000 respectively. Guarantee facility of £59,150 000,000 for a term of three years and setting out the security arrangements in respect of the facility.

(4) Counter Indemnity Agreement dated 4 November 2005 between Piebet and Hambros CI under which Piebet agrees to indemnify Hambros CI for any claims made under the Guarantee with Hambros London.

(5) Security Interest Agreement dated 4 November 2005 between Hambros CI and Piebet assigning as collateral all monies in a SG Hambros Nominees (Jersey) account and giving Piebet access to funds in that account only if they exceed the Security Amount, which is equal to the amount of the loan made under the Guarantee Facilities plus accrued interest.

(6) Secondary Loan Agreement dated 4 November 2005 between Piebet and Betex providing that if there is a deficit under the loan agreements made by the LLP Members with Hambros, Piebet will make a loan to Betex of an amount equal to that deficit. Stating that if on the 25th anniversary of the drawdown of the Secondary Loans the loans have not been recouped in full, the members will be liable to pay Piebet an amount equal to the amounts which Piebet has not recouped.

(7) Set off Agreement and Charge over Deposit between Hambros London and Hambros CI dated 4 November 2005. This records Hambros CI's agreement to deposit a sum equal to the sum deposited with it by Piebet (£53,344,831.81) with Hambros London which is subject to rights of set-off in favour of Hambros London by reference to the guarantee which it has given to Hambros CI.

187. Various correspondence between Charterhouse and Hambros and Hambros' internal communications including:

(1) email of 10 November 2005 (from Adrian Rowland to Eric Barnett) saying:

> "*Please find..... a copy of a credit proposal.....for another round of "Software" planning"..... I have been through it and am satisfied with the risks and that it is in line with the other 2 Software deals which we have done over the last 12 months"* and from Terry Brown *"One sensible multi-part question... who is it that decides £65m is a reasonable price to pay for the software licence and how do they reach that conclusion.... which presumably has to be accepted by the tax man*"

188. **HMRC correspondence**

(1) Notice of Enquiry dated 31 October 2006

(2) Closure Notice dated 7 February 2012

(3) Letter dated 4 July 2008 from HMRC to Charterhouse referring to "*technical and legal arguments that could well impact on the apportionment and/or tax treatment of the sums involved in the transaction*".

Oral evidence

189. We saw witness statements from**:**

(1) Darren Lee dated 27 January 2016

(2) Peter Hargreaves dated 27 January 2016

(3) James Edmond (first & second statements) dated 27 January 2016 & 27 May 2016

(4) Rob Earle (first & second statements) dated 26 January 2016 & 26 May 2016

(5) Expert witness report of Dr Stephen Castell dated 9 August 2016 (appointed by the Appellants)

(6) Expert witness report of Mr Anthony Sykes dated 11 August 2016 (appointed by HMRC)

(7) Joint expert statement dated 3 November 2016

Each of these witnesses also gave oral evidence to the Tribunal and were cross-examined.

The trading question

Whether the Appellants carried on a trade

190. Mr Earle was responsible for the development of the Betex Software in New Zealand through his company IGS Ltd (NZ) ("IGS"). He told us that he had started to develop the Betex software in 2000 through his company EMG and estimated that £1.8 million was sufficient to allow him to launch the product in 2006.

191. IGS had done a lot of market research about the gaming market and commissioned two reports (the MECN report and the Vantis report).

192. He described the betting software which was licensed to Betex as leading edge and as a competitor to other market participants, especially Betfair**.** Receiving the funding from Betex allowed him to move forward with launch plans**.**

193. Mr Earle told us that the UK was the main market for Betex because it was a gambling hub. Having a UK gaming licence meant that bets could be taken from all over the world.

194. He explained his medium term aim was to launch an IPO on AIM with the Betex Software, which was why he needed the option to buy back the rights to exploit it.

195. Mr Lee was a client of Charterhouse and a financial trader as well one of the investors in Betex and Daarasp. He explained why he was interested in the Betex Software and why he believed it had commercial potential despite the fact that larger competitors (Betfair) already existed in the market. In his view the Betex interface was similar to Betfair, which was already very successful but was better than Betfair because it had a lot more colours on its inter-face and was "*more rounded and user friendly*".

196. Mr Hargreaves also insisted that Betex was a real commercial undertaking at the time when the investments were made and that he had confidence in the arrangements. He referred to the MECN, Valuation Consulting and Vantis reports to support this view.

197. Mr Sykes' opinion was that although the Betex software was properly written and complete in 2006, it was not an operable system because it had no software to allow for banking transactions**.**

Findings of fact

198. *On the basis of this evidence the Tribunal accepts that those who were involved in the Betex investment in 2005 and 2006 believed that the betting software which was licensed to Betex had commercial potential, despite the existence of at least one very significant competitor in the field. Mr Earle, as the developer of the software, had a long term plan to make money from the Betex Software which was not dependent on Betex's investment in it.*

*What activities were carried out using the Betex Software from November 2005 to April 2006***?**

199. Mr Edmond said that in November 2005 the Betex Software was not working because it had not been fully developed, it had not been launched in the marketplace.

200. Mr Lee said that he traded using the Betex Software as soon as it became available, putting £5,000 on deposit in 2006 and generating profits of £1,995.76. He referred us to his bank statement for July 2008 showing the repayment of his deposit plus profits amounting to £6,995.76 in total.

201. Of the Betex Software at this time, Dr Castell said **"***the basic functionality was there but I could not... exercise it to the full extent of its probable capabilities***"**

202. Mr Sykes said that the Betex Software only had limited functionality in 2006 and while it could have been used to do some transactions, it was essentially in prototype form at this stage**.** In his view there was no evidence of the exploitation of the Betex Software and only "minor runs" had been undertaken using it**.**

Findings of fact

203. *We have concluded that any exploitation of the Betex Software licence undertaken by Betex during the accounting period in which expenditure was incurred on the Betex Software licence was minimal. The functionality of the Betex Software was limited at this period and Betex derived a very small amount of income from exploiting the Betex Software licence with nearly all of its income being derived from warranty payments, as evidenced by its accounts for this period*.

What activities were carried on in later accounting periods?

204. Mr Earle said that in the UK the Betex Software was operated through another bookmaker's premises and that initial profits were low because of a lack of opportunities for advertising and animosity with the UK bookmaker through which they were operating. The payment solution which was needed to make the system available to the public also took longer than anticipated to develop.

205. Mr Earle said that by May 2006 the functionality of the "API's" was there but the software's mobile front end was not available.

206. When profits remained low (as set out in the progress reports of July 2007) he had raised questions about this and it was explained that the regulatory changes in the US market (The Unlawful Gaming Act) had an impact on Betex's ability to raise further capital, saying that as a result "*everyone in the UK went running for cover*".

207. Mr Earle said he spoke to Mr Edmond about these issues and that Betex members were raising concerns.

208. Mr Hargreaves referred to a presentation made to LLP members in May 2006 in which current results for Betex showed a "modest revenue".

Findings of fact

209. *From the evidence which we saw and from what witnesses said before the Tribunal, the income generated by Betex deriving from the exploitation of the Betex Software licence from April 2005 until at least the end of 2006 was minimal.*

Why were no profits ultimately generated?

210. We were provided with several different explanations for the failure of Betex to make any profit, but the regulatory changes in the US were consistently referred to as one of the main reasons for this failure.

211. Mr Lee said that no further profits were made from the Betex Software because of the US Unlawful Gaming Act which was introduced in September 2006. That affected the whole market, including Betfair and UK companies because they were licensed to deal with US customers too.

212. Mr Earle told us that further funds would have been raised for Betex had it not been for the US regulatory changes and that he had planned for an IPO in late 2007, meaning that Betex would have owned the Software licence for the two years from 2005 – 2007.

213. Mr Edmond said that the long term aim was for Betex and IGS to get sufficient market share to be a thorn in the side of Betfair, who would then buy them out. He explained that he viewed this as an alternative exit strategy to the IPO envisaged by Mr Earle.

214. Mr Hargreaves gave three reasons for the ultimate failure to make profits (i) The introduction of the US Unlawful Gaming Act which prevented cross-border payments being made in the matched gambling market, (ii) the global recession and (iii) Betfair unexpectedly investing a "wall of money" into its own marketing.

215. Mr Hargreaves said that in response to these problems other markets had been considered by Betex; Greece and Turkey were under consideration in July 2007.

Findings of fact

216. *The reasons given by those involved for the failure by Betex to make any profits had been recognised as potential problems by market commentators (such as MECN) at the time when Betex acquired the Software licence, but those involved with Betex seem not to have taken these issues seriously.*

Marketing and business management – who was the directing mind of the LLP?

217. Mr Earle explained that IGS was the entity which developed the Betex software in New Zealand in conjunction with Hewlett Packard, who were used to vet the software before it went live. Hewlett Packard were a service provider to IGS and provided all of the technology for the hosting services in the UK.

218. He said that having received £1.6 million from Betex, IGS was allowed to continue to develop the software as if they owned it. He described the purchase by Betex as "a performance related purchase" and said it was important that he had exclusive buy-back rights.

219. Mr Earle accepted that while Betex had the exclusive licence in the Betex Software, it was IGS, the development company who remained the distributor and developer and improved the asset and promoted it. He accepted that no one from Betex ever asked questions about how the software was being improved or promoted.

220. Mr Earle confirmed that all of the investors in Betex had access to the Betex website so they were aware of the development which was being done but said that he did not have any direct contact with any Betex investors.

221. Mr Edmond said that he had ad-hoc conversations with Mr Earle leading up to the launch of Betex and that there were no formal arrangements between Betex and Mr Earle. He had not been involved in finding clients for the software, that was the role of IGS (UK), (the operating company set up to develop the software and obtain a UK licence). He said that Betex was not competent to go out and find markets for the product and that the real expertise to exploit the software was with IGS and EMG. In any event the circumstances in the US, with people being arrested "*really did throw a spanner in the works. Prior to that, this looked very promising, very good, everything got set off straight and that just kyboshed it*".

222. Mr Hargreaves said that he had not been involved with the commercial negotiations. He did not make presentations to members and did not draft the PMID. It was his understanding that the exploitation and development of the Betex Software would be undertaken by IGS because they had a commercial interest in exploiting it, although he could not identify a contractual obligation which set this out or any legal means by which Betex could hold IGS to account. Mr Hargreaves accepted that Betex did not have any employees who could develop the Betex Software, but stressed that IGS was obliged to do this.

223. Mr Hargreaves told us that despite IGS failing to produce profits from the software for Betex, no one at Betex raised any concerns because they understood the commercial difficulties and it would not have been realistic to look for an alternative distributor**.**

224. Mr Sykes said that the marketing and promotion strategy which he saw for Betex was too lacking in detail to be a proper strategy document**.**

Findings of fact

225. *None of the Betex members had any direct involvement with its core business, the exploitation and development of the betting software, that continued to be managed by Mr Earle in New Zealand, despite the fact that an exclusive licence had been granted to Betex.*

226. *None of the Betex members raised questions or issues about the improvement or promotion of the Betex Software.*

227. *Betex did not have the know-how or resources to exploit the Betex Software licence itself and no oversight of the activities which it outsourced.*

Expenditure Incurred

Whether expenditure was incurred and if so, what was the expenditure incurred on, the software licence or something else?

The valuation of the Betex Software licence

228. The Betex Software licence was valued at £65 million in November 2005 when the first tranche of investment was received through Betex. That value was included in the PMID which was provided by Charterhouse through Mr Edmond.

229. Mr Edmond said that he had relied on the reasonable projections from Mr Earle, which were provided to Vantis in December 2004 and significantly discounted those numbers. He was adamant that his valuation (of up to £66 million) was a fair assessment of value of the Betex Software licence based on the information which he had.

230. Mr Earle said that he estimated the value of his company, EMG, which was developing the Betex Software as £200 million based on its potential revenue earning capacity and by comparison with the profits earned by Betfair. He had also relied on the market research carried out by MECN, which was encouraging. The £65 million price put on the software by Mr Edmond was lower than his estimate. Mr Edmond thought that Mr Earle's pricing was too aggressive.

231. Mr Edmond explained that while he did not have any direct experience of on- line betting himself, his knowledge of the industry was based on general awareness, the potential for growth as shown by companies such as Betfair, which he described a phenomenal, and the MECN report. He did not consider it necessary to get a third party valuation of the software and did not consider it necessary to take account of potential regulatory restrictions in valuing the software.

232. He had also relied on the comments in the Vantis report, which he considered to be impartial even though one of its partners was also the finance director of IGS. He accepted that the MECN report was a report on the general status of the on-line gambling industry, not EMG/IGS in particular and said that he did not have the information to produce totally independent projections for the Betex Software.

233. Mr Edmond explained that his pricing methodology was the same methodology as he had applied to the Daarasp Software; he had projected forward the likely cash flow generated by the Betex Software licence and then applied a discount percentage to those figures. He had also taken account of returns for the first 15 years of the term of the licence only.

234. Mr Edmond had refined his pricing to include "high, medium and low" profit projections for the Betex Software licence. His financial projections were based on a number of assumptions but did not include any risk of government restrictions in the on-line betting industry. Mr Edmond could not explain exactly where the number of users which he had put into his profit projections derived from.

235. In respect of the valuation report provided by Valuation Consulting, Mr Edmond accepted that they had approached the valuation of the software in a different way, but had started from figures provided by IGS. Mr Edmond pointed out that they had produced a range of valuations in their final report from £60 million to £75 million, depending on what discount rate was applied.

236. Mr Edmond said *"I did not have the information to go out and get independent information, I was provided with information that made sense. My starting point, in terms of the projections in the PMID, was to take this report, these projections, which all appeared to be reasonable....."*

237. Mr Edmond could not explain how the second tranche of the Betex Software licence (which was invested in March 2006 and related to South African and South American software rights) had been valued, but described it as a mechanism for dealing with a situation in which no further funds were raised, so some territories would be excluded from the software licence. Mr Edmond said that he had no view on what the person to person betting markets were like in either South Africa or South America. He said "*They [IGS] did not want to enter into an agreement whereby they were giving the worldwide rights for the full amount and then finding that further funds, for some reason, didn't come through*"

238. Mr Edmond could not explain the email of 4 November 2005 which seemed to refer to Valuation Consulting having revised their valuation of the Betex Software licence in response to a client request, headed "*revision due to client request*".

239. Mr Edmond said that his previous experience with the valuation and profitability of the Daarasp LLP may have influenced the discount level which he applied to the Betex Software licence, but that it had not led him to believe that regulatory risks needed to be taken account of.

240. Mr Lee explained that he had not asked specifically about how the Betex Software licence had been valued, but he had seen Mr Edmond's projections. He relied on the numbers which were provided in the PMID. It was his view that it was possible for a new player like Betex to break into this market.

241. Dr Castell was clear that the valuation of the Betex Software licence was "cut and paste" from the Daarasp valuation saying "*the essential methodology for valuation is precisely the same"*. He had looked carefully at the Valuation Consulting report and decided that it was not unreasonable. He accepted that existing competitors in the market (mainly Betfair) meant that Betex's marketing strategy was relevant to this valuation, but stressed that Betex's business plan assumed a relatively small market share. Dr Castell said that Betex's business plan did not include the sale of the software.

242. Mr Hargreaves said that he did not test the valuations provided or obtain further independent valuations or test the profit forecasts, it was not his job to re-do the valuation computations. His role was to form an opinion on the reports which had been provided. He believed that the profit expectations were reasonable overall. He stressed that he was not an expert in valuations himself and resisted the suggestion that the valuations which had been received were not truly independent saying that there was no true, objective price, for this software.

243. Mr Sykes said that it was very unusual to purchase software for a period as long as 24 years and make the payment for it upfront. There were real issues with the maintenance of the software over that period and he had not ascribed any value to the undertaking given to Betex by IGS.

244. He also thought that there were significant competitors already in the market; Ninja Traders and Betfair, with the latter having a huge position in the market which would take a significant amount of marketing effort to compete with.

245. Mr Sykes' valuation was based on a "lines of code" method to establish the cost of building the software, rather than an attempt to value the software as a finished, marketable product. Mr Sykes expressed some doubts about the quality of the marketing material which he had seen, but did accept that, if a business plan and strategy was in place, the valuation method applied by Valuation Consulting was an appropriate method.

246. Mr Sykes also said that in his experience it was far from common for an upfront payment to be made for incomplete software and that no one would ever pay for a 24 year licence up front. Annually in advance was in his view the more normal payment profile.

Findings of fact

247. *The valuation of the Betex Software licence was made without reference to an independent third party and was based on a valuation within a range which was ultimately decided by Mr Edmond at Charterhouse. There were some discrepancies among those involved about what the end game was for the Betex Software licence, despite the fact that this should have had an impact on its value at the time when it was acquired by Betex.*

The object of the expenditure – the anti-avoidance rule at s 215 CAA 2001

248. Mr Edmond accepted that the starting point for the Betex investment was to find businesses which could qualify for the 100% first year allowances. Start up businesses like Betex were bound to have losses in their first year and the availability of capital allowances was a factor in deciding whether to undertake the business.

249. As for Daarasp, a DOTAS disclosure had been made as a matter of caution and not because it was accepted that the Betex transaction was disclosable under those rules.

250. Mr Hargreaves was candid that obtaining the tax losses in the first accounting period was an expectation of the investors and that the reason why the funding for Betex was split 60/40 was because only 40% capital allowances were available in this case (unlike the 100% allowances available to Daarasp). He resisted the suggested that the full payment was made to Piebet on day one because of the need to obtain capital allowances for the full amount, merely saying that it was hard to posit different ways of doing the deal and that all transactions could be done in different ways.

Findings of fact

251. *The availability of capital allowances was a major factor for those at Charterhouse who implemented the Betex structure and for the members who invested in it.*

The financing arrangements – the warranties and the loans from Hambros and the Secondary Loans

252. Mr Edmond could not explain why there was a first round of financing in November 2005 and a second round in March 2006 for Betex, but thought that this was driven by the need to obtain financing for the developers in New Zealand so they could get on with the project. He confirmed that all aspects of the financing were pro-rated in November 2005 to take account of the fact that not all of the required capital had been raised.

253. Mr Edmond said that the entity Piebet was need as an intermediary to "smooth the transactions", controlling what cash was available, providing a security route for funds and the warranty payments.

254. Redbar had been included because it was easier to have a single nominee company making all of the loans to the Betex members.

255. Mr Edmond confirmed that there was a warranty payment due from Piebet to Betex on a quarterly basis and then an overriding warranty of £20 million.

256. Mr Edmond was clear that investors did take a risk on their Secondary Loans in Betex; these loans were not limited recourse. Any payments under the Secondary Warranty would only cover amounts up to £20 million. The only way of removing your risk as an investing member was to exit the partnership by selling your share to the general partner, Piedama, which is what he had done.

257. Mr Edmond accepted that the London and Jersey Hambros banking arrangements were essentially providing funding through blocked accounts for the purpose of investing in the Betex Software.

258. When asked whether he was really taking any risk by investing in Betex Mr Lee accepted that any Secondary Loans would be re-paid either through funds received on the exercise of the option, through the warranty payments or what he described as "paid out through the structure". His explanation of the risk being taken was that if the banks

who were guaranteeing the Secondary Loans had gone bust, he would have to make a payment as an investor.

259. Mr Earle said that if they had had to pay the £76 million to Piebet for the buy-back and had not yet received the full £65 million from the software sale, they would have obtained the difference from Betex.

260. Mr Hargreaves said that Hambros were chosen as the bank in the Betex transactions because they had previously worked with them and had an ongoing relationship.

261. Mr Hargreaves also said that the secondary loans were technically not limited recourse and resisted the suggestion that the mis-match in payments from Betex to Piebet and from Piebet to EMG was driven by the need to claim capital allowances on the full amount of the payment**.**

262. Mr Hargreaves described the warranty payments as required to provide protection to the members if the arrangements were not commercially successful, although everyone did start with the intention that the business would be successful.

Findings of fact

263. *Looking at the financing structure as a whole, the investors' loans were limited recourse in substance if not in form, while the warranty payments removed any risk from the members that the software licence would not generate at least an interest rate return.*

264. *The ultimate seller of the Betex Software, EMG, only received £1.64 million for the software on day one. Other than a small amount of "further initial consideration" which was payable to EMG, the remaining payments were contingent on the Betex Software being profitably exploited by Betex.*

The two option arrangements

265. Mr Edmond could not explain how the options would be dealt with if, as envisaged by Mr Earle, there was an IPO over the Betex Software, only suggesting that there would have to be some arrangements to buy out the option.

Findings of fact

*This section sets out all of the facts which we have found in the evidence set out previously and which form the basis of our decision***:**

Daarasp

Whether the transactions alleged to have taken place by the Appellants did in fact take place:

266. The March 2004 version of the Daarasp Software at best had limited functionality and may have been able to be used for some basic equity trading transactions.

267. The Appellants have not demonstrated that any live trades were done utilising the Daarasp Software before May 2004 on either the NYSE or the Karachi stock exchange.

268. The Daarasp Software was at most used for a small number of live equity trades through brokers on the NYSE during the latter half of 2004.

269. It is not possible to know with any degree of certainty what coding had been developed and was included in the Daarasp Software which was licensed to Daarasp in March 2004 by reference to the CDs which were reviewed by the two experts.

The trading question

270. The Appellants have not demonstrated that the Daarasp Software could be used for live transactions or that any live equity transactions were done using the Daarasp Software during the accounting period (from 17 February 2004 to 5 April 2004) in which Daarasp acquired the Daarasp Software licence.

271. Daarasp did not have permission to deal directly on either the NYSE or the Karachi stock exchange at this time and all deals had to be done through brokers who were members of those exchanges.

272. As evidenced by its accounts, Daarasp generated a small amount of fee income from 1Ecomnet.com (via Parjun Enterprises) but it is not clear what activities those fees related to. The invoice which we saw between 1Ecomnet and Parjun Enterprises dated 31 March 2004 in respect of these fees did not refer to equity trading

Activities in later accounting periods

273. Daarasp's only real source of profit from 6 April 2004 until 5 April 2005 was the warranty payments. Its exploitation of the Daarasp Software licence for on-line equity transaction activities was minimal during this period.

274. During this period few actions were taken by any of those involved with Daarasp to ensure that its business was on track to generate the profits which had been predicted in the PMID.

275. Daarasp did not have a framework or resources to support significant trading activities and no oversight of the activities which it outsourced to others.

Why were no profits made?

276. The explanations which we were given for Daarasp's failure to generate income were inconsistent and demonstrated that there was no coherent and businesslike approach from anyone involved in Daarasp to ensure that the Daarasp Software licence

was properly exploited to earn profits, either during the relevant accounting period or any later periods.

Marketing and business management

277. It is not clear who was actually responsible for making business decisions on behalf of Daarasp and who, if anyone, was providing a business plan.

278. The only person with an extensive understanding of Daarasp's business was Mr Curchod. He was not directly involved with Daarasp and seemed to feel that he had intentionally been kept away from the business by Mr Makhdumi when he asked difficult questions. Those who were more directly involved absolved themselves from responsibility for making significant business decisions. With the exception of Mr Lee, none of the Daarasp LLP members took any active role in the management of its business either.

The valuation of the Software licence

279. While many of those involved in the valuation of the Daarasp Software licence believed that the software was valuable and novel, none of those who were involved in the valuation process were experts in valuing software of this type and relied on other sources as the starting point for the valuation. The valuation was described by those who were involved as "rough and ready". Despite this, no third party assessment of the valuation of the Daarasp Software licence was carried out.

The object of the expenditure

280. The availability of capital allowances was a major factor for those at Charterhouse who implemented the Daarasp structure and for the members who invested in it.

The financing arrangements

281. Looking at the financing structure as a whole, the members' loans were limited recourse, in substance if not in form. The warranty payments removed any risk that the members would not obtain at least an interest rate return on their investments, even if the Daarasp Software licence did not generate any profits.

282. The ultimate seller of the Daarasp Software, Parjun Enterprises, only received £1.4 million for sale of the licence on day one. The remaining payments were contingent on the Daarasp Software being profitably exploited by Daarasp.

Betex

The trading question

283. Those who were involved in the Betex investment in 2005 and 2006 believed that the betting software which was licensed to Betex had commercial potential, despite the

existence of at least one very significant competitor in the field. Mr Earle, as the developer of the software, had a long term plan to make money from the Betex Software which was not dependent on Betex's investment in it.

284. Any exploitation of the Betex Software licence undertaken by Betex during the accounting period and at the time when expenditure was incurred on the Betex Software licence was minimal. The functionality of the Betex Software was limited during Betex's first accounting period. Betex derived a very small amount of income from exploiting the Betex Software licence with nearly all of its income being derived from warranty payments, as evidenced by its accounts for this period.

Activities in later accounting periods

285. The income generated by Betex deriving from the exploitation of the Betex Software licence from April 2005 until at least the end of 2006 was also minimal.

Why were no profits made?

286. The reasons given by those involved for the failure by Betex to make any profits had been recognised as potential problems by market commentators at the time when Betex acquired the Software licence, but those involved with Betex seem not to have taken these issues seriously.

Marketing and business management

287. None of the Betex members had any direct involvement with its core business, the exploitation and development of the betting software, that continued to be managed by Mr Earle in New Zealand, despite the fact that an exclusive licence had been granted to Betex.

288. None of the Betex members raised questions or issues about the improvement or promotion of the Betex Software.

289. Betex did not have the know-how or resources to exploit the Betex Software licence itself and no oversight of the activities which it outsourced.

The valuation of the Software licence

290. The valuation of the Betex Software licence was made without reference to an independent third party and was based on a valuation within a range which was ultimately decided by Mr Edmond at Charterhouse. There were some discrepancies among those involved about what the end game was for the Software licence, despite the fact that this should have had an impact on its value at the time when it was acquired by Betex.

The object of the expenditure

291. The availability of capital allowances was a major factor for those at Charterhouse who implemented the Betex structure and for the members who invested in it.

The financing arrangements

292. Looking at the financing structure as a whole, the investors' loans were limited recourse in substance if not in form while the warranty payments removed any risk from the members that the Software licence would not generate at least an interest rate return.

293. The ultimate seller of the Betex Software, EMG, only received £1.64 million for the payment on day one. Other than a small amount of "further initial consideration" which was payable to EMG, the remaining payments were contingent on the Betex Software being profitably exploited by Betex.

Question 1 - The Closure Notices

What issues can properly be treated as under appeal to this Tribunal?

294. The Daarasp Closure Notice issued on 26 January 2011 and the Betex Closure Notice issued on 7 February 2012 are identical save for the figures referred to, and are brief in both cases. The Betex Closure Notice states:

"*My conclusion*

That following the detailed review of the relevant partnership documents and the lengthy discussions held with James Edmond of Charterhouse (The Promoter) I conclude of the losses claimed, only a currently unquantifiable part may be allowable.

I have amended your partnership loss figure to reflect this. The figure for your partnership loss is as follows:

The original partnership loss figure was £25,482,181.00

The partnership loss figure is now £0.00"

295. While conclusions are stated, nothing is stated in either of the Closure Notices which might be treated as reasons for the conclusion that "*of the losses claimed, only a currently unquantifiable part may be allowable"*.

The Appellants' arguments

296. In respect of both Daarasp and Betex the Appellants argue that the terms of the Closure Notices mean that the only issues under appeal relate to the value of the Daarasp and Betex Software licences and the functionality of the software.

297. Any issues which would result in the complete denial of capital allowances to the Appellants are outside the scope of the Tribunal's jurisdiction because they are outside

the terms of the Closure Notices, which refer to disallowing an "unquantifiable part", not all, of the capital allowances claimed.

298. Specifically the Appellants argue that what Mr Thornhill referred to as the "knock out" arguments could not be considered as part of this appeal:

(i) the question of whether the Appellants carried on a trade and whether the transactions referred to in the Appellants' statement of case actually took place

(ii) whether Daarasp was a "small enterprise" under s 45(1)(b) CAA 2001

(iii) whether the "long life asset" exclusion at s 46 CAA applied to Daarasp

(iv) whether the anti- avoidance rule at s 215 CAA applied.

299. The Appellants rely on the statements in *Tower MCashback* to support this restrictive approach to the interpretation of the Closure Notices; "*The appeal against the conclusions is confined to the subject matter of the enquiry and of the conclusions*" Walker LJ at [16].

300. Only the conclusion in the Closure Notices and any arguments relevant to support that conclusion are open to appeal. The actual amendment in the Closure Notices reducing the capital allowances to nil is not part of the conclusion of the Closure Notices.

HMRC's arguments

301. HMRC say in respect of both Daarasp and Betex that the terms of the Closure Notices issued to each of the Appellants do not restrict the Tribunal to considering only those matters which reduce rather than eliminate the capital allowances available.

302. HMRC also rely on statements made in the *Tower MCashback* decision, including that there is no requirement for HMRC to set out their reasons in a closure notice:

Henderson J at p 735 [113]

> "There is no express requirement that the officer must set out or state the reasons which have led him to his conclusions and in the absence of an express requirement, I can see no basis for implying any obligation to give reasons in the closure notice"

and stressing that it is the Tribunal's duty to consider all relevant legal issues in carrying out their duty to determine the correct amount of tax due:

Henderson J referred to at p735 [115]

> "if the commissioners are to fulfil their statutory duty under that section [section 50], they must in my judgment be free in principle to entertain legal arguments which played no part in reaching the conclusions set out in the closure notice"

303. HMRC suggest that if there is a contradiction between the *Tower MCashback* decision and the later First-tier Tribunal decision in *Towers Watson*, which adopted a more restrictive interpretation of a closure notice, the decision of the higher court in *Tower MCashback* is to be preferred. In any event, unlike in the *Towers Watson* case, the arguments being made by HMRC in this case are not inconsistent with their other arguments, but are a logical first argument to decide whether allowances are available at all.

304. The Tribunal should take a broad approach to the issue before it because its primary duty is to ensure that the correct amount of tax is collected in accordance with s 50(6) and (7) Taxes Management Act 1970.

305. On the question of how the Closure Notices should be construed the Respondents say that ordinary principles of contractual construction are applicable; the question is how a reasonable person would have understood the Closure Notices taking account of their context. A closure notice should not be construed as if it were a statute:

> "It is not appropriate to construe a closure notice as if it a statute or as though its conclusions, grounds and amendments are necessarily contained in watertight compartments, labelled accordingly" Kitchin LJ in *Fidex* at [51].

306. The fact that the Closure Notices amended the amount of capital allowances available to nil indicates that HMRC did not consider that any losses were available and the reference to "*only a currently unquantifiable part may be allowable*" does not indicate that HMRC believed that some losses would be available.

307. The interpretation of the Closure Notices has to take account of the correspondence between the parties as part of the enquiry which gave rise to the Closure Notice, which included considering the availability of the losses in their entirety, such as Charterhouse's letter to HMRC of 27 January 2010 (re Daarasp) which referred to s 48 CAA 2001 and HMRC's letter to Charterhouse (re Betex) of 4 July 2008 which referred to the tax treatment of the sums involved in the transaction.

308. A reasonable recipient of the Closure Notices would have understood that HMRC's view was that no part of the losses was available to the Appellants.

309. *Tower MCashback* supports a wide interpretation of the Closure Notices in this case, subject only to ensuring that that there is no prejudice to the Appellants and that there is a fair hearing, as stipulated by Moses LJ

> "But the fact that the inspector had indicated that there might have been other issues which arose was relevant to the exercise of the Special Commissioner's case management powers. The taxpayer was not deprived of an opportunity fairly to marshal evidence as to other grounds subsequently advanced by the Revenue on appeal" referred to by Walker LJ at p 769 at [17]

310. In this case the Appellants have been well aware of all of the arguments raised by HMRC since the original Notices of Enquiry were issued and throughout later correspondence. The Appellants have had plenty of time to, and have, marshalled relevant evidence on all of the points raised by HMRC and have not been "ambushed".

Decision on question 1 – The Closure Notice question

The approach to interpreting the Closure Notices

311. We agree with the approach of HMRC that a closure notice cannot and should not be interpreted as if it was a statutory provision. It is intended to communicate HMRC's decision to a taxpayer and so should be interpreted as a layperson and not a lawyer's document.

312. On the other hand, HMRC have to accept that a closure notice is a significant document from a taxpayer's perspective and should make clear HMRC's view of the correct tax which is due and the reasons for this. As stated in *Tower MCashback*:

> "In issuing a closure notice an officer is performing an important public function in which fairness to the taxpayer must be matched by a proper regard for the public interest in the recovery of the full amount of tax payable" Walker LJ p769 at [18]

313. In an ideal situation, a closure notice would, as suggested in *Tower MCashback*, state clear conclusions by reference to a single clear point at issue.

> "In a case in which it is clear that only a single specific point is in issue, that point should be identified in the closure notice. But if, as in the present case, the facts are complicated and have not been fully investigated, and if their analysis is controversial, the public interest may require the notice to be expressed in more general terms" Walker LJ p769 at [18].

314. This case certainly falls into the second category, but the question remains whether even accepting that this is a complicated case, the "general terms" used by HMRC are adequate to include HMRC's arguments that none, rather than only part of, the capital allowances claimed should be allowed.

315. HMRC suggest that it is possible to extrapolate back from the amendment (no capital allowances available) to construe the reasons, but we have some doubts about the logic of this. In our view while the actual amendment was a complete denial of capital allowances, the conclusion stated in the Closure Notices did not suggest that this was the necessary result of HMRC's conclusion.

316. In our view on its face the Closure Notices do not identify even in the "general terms" referred to by Lord Walker, the full scope of the points in issue.

317. However, we are clearly allowed to look further than the face of the Closure Notices, again relying on *Tower MCashback*;

> "Notices of this kind, however, are seldom, if ever, sent without some previous indication during the enquiry of the points that have attracted the officer's attention. They must be read in their context" Hope LJ p 792 at [84].

318. In our view there is evidence in the Notices of Enquiry to indicate that HMRC were considering a range of reasons why the capital allowance claims made may be disallowed in whole or in part. HMRC's Notice of Enquiry to Daarasp of 22 December 2004 says "*My enquiries centre on the partnership's trade and capital allowance claims*". Exactly the same phrase is used in the Betex Notice of Enquiry of 31 October 2006.

319. We also accept Ms Nathan's point that other correspondence between the parties' representatives and HMRC referred to arguments raised by HMRC which would have led to the complete denial of capital allowances.

320. This approach is supported by the suggestion, particularly in the *Tower MCashback* decision, that our role should not be unduly restricted by the terms of the Closure Notice, picking up on the statements of Dr John Avery Jones in *D'Arcy*:

> "The appeal against the conclusions is confined to the subject matter of the enquiry and of the conclusions. But I emphasise that the jurisdiction of the Special Commissioners is not limited to the issue whether the reason for the conclusion is correct. Accordingly, any evidence or any legal argument relevant to the subject matter may be entertained by the Special Commissioners subject only to his obligation to ensure a fair hearing" p 768 [16] Walker LJ

321. On that basis the scope of this appeal should be limited only for two specific reasons:

(1) The appeal should not be allowed to "*open the door to a general roving enquiry into the relevant tax return*" and the taxpayer should not, by reason of new arguments being introduced, be deprived of an opportunity to properly respond to them.

In our view by including arguments about the nature of the Appellants' trading activities and considering other detailed rules which are relevant to the availability of the capital allowances which are the subject of this appeal, HMRC have not advanced issues which are not relevant to the core question of whether capital allowances are available.

(2) If any purported extension of the legal arguments under consideration by HMRC has put the taxpayer at an unfair disadvantage and "ambushed" him with arguments to which he has not had a chance to respond. This could and should be managed as part of the case management process and in our view that has been achieved here.

In our view there is no question in this appeal of the Appellants not being sufficiently aware of the arguments which were to be raised by HMRC. The best test of this is to consider the information provided by the parties in response to the Tribunal's directions, intended to ensure that the parties were aware of the issues in dispute before they got to the Tribunal hearing.

HMRC's proposed statement of issues provided in October 2015 dealt in some detail with the points which they now raise as did their amended statement of case also produced in 2015.

322. If the *Towers Watson* case needs to be distinguished we would say that, rather than considering an issue which was a fundamental component of the tax losses claimed (the valuation of the goodwill) the Tribunal in that case was asked to consider a parallel issue (the amortisation of the goodwill) and one which had not been raised prior to the Tribunal hearing.

323. In these circumstances there is no reason for the Tribunal to accept a restricted approach to the Closure Notices for fairness reasons, on the contrary to fail to consider issues which are fundamental to the availability of the disputed losses would result in the Tribunal providing only a partial decision.

324. For these reasons we accept HMRC's position on this point and are proceeding on the basis that each of the "knock-out" points are under appeal and open to us to consider as part of this decision.

Question 2 - The Trading Question

The Appellants' arguments

Daarasp

325. The Appellants say that the evidence which they have produced demonstrates that Daarasp did carry out the transactions referred to during its first two accounting periods.

326. Mr Thornhill pointed out that HMRC had raised the suggestion that the Daarasp Software had never been functional rather late in the enquiry process; only in 2016 when Mr Sykes, HMRC's expert witness, said that the disk which he saw did not contain fully functioning software.

327. In contrast Daarasp has always maintained that the Daarasp Software was functional in early 2004 and provided evidence that trades were carried out using that software in March 2004 in New York. It is only because the 2004 version of the Daarasp Software has not been preserved that its functionality has been called into question.

328. The disk provided to Mr Sykes is unlikely to be the disk containing the March 2004 version of the software which was originally held in escrow (some of the dates it

contains are as late as April 2005) and the versions held in escrow were continually being updated as the software was developed. As suggested by Mr Curchod, the disk which Mr Sykes saw looked more like a distribution version of the software rather than the original 2004 escrow version.

329. The Appellants have provided evidence of the trades done using the Daarasp Software, Mr Makhdumi was clear that the software was completed in March 2004 and was used to trade on the Karachi stock exchange in June and that trading was undertaken through Dr Shaheen Ahmad in New York in early 2004.

330. This is supported by Mr Curchod's statements that he saw a working system of the Daarasp Software in January 2004 which was only weeks away from completion and saw live demonstrations in February 2004 through Dr Shaheen's computer describing the system as "a working system as opposed to a first-cut prototype". Mr Curchod was sufficiently impressed with the system to want to invest in it himself and stated (in March 2004) that the existing version of the Daarasp Software satisfied the requirements of a day trader.

331. Daarasp's accounts and bank accounts show receipts from 1Ecomnet in April 2004 (arising from March 2004 trading transactions), and in August 2004. As explained by Mr Makhdumi these payments were for the use of the Daarasp Software. Mr Makhdumi also provided a list of trade transaction reports for May 2004 and said that he saw trades being carried out through a brokerage house (Idress Adam) in Karachi. It was possible to trade in both New York and Karachi at this stage by using a broker without the need for regulatory permissions.

Daarasp and Betex

332. In the Appellants' view, both Appellants were exploiting software by earning commissions, which is a trading activity; similar to activities which are carried out by commercial concerns.

333. On behalf of the Appellants Mr Thornhill stressed that the facts in these appeals were not like the film investment cases where the right to acquire a series of payments under a sale and leaseback transaction was determined to be an investment rather than a trading activity. These transactions were not sale and leaseback transactions.

334. The real comparison is not with the film sale and leaseback cases, but with *Ensign Tankers*, in which Lord Templeman held that the partnership's activities were trading activities:

> "The task of the Commissioners is to find the facts and apply the law.....The facts are undisputed and the law is clear. Victory Partnership expended capital of $3 ¼ million. 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..... The section is not concerned with the purpose of the transaction but with the purpose of the expenditure" p677 D - E

335. The warranty payments received by each of the Appellants were additional trading profits, being commercial income from their trades. The parties were keen to ensure that the Software licences were acquired at a fair market price taking account of a predicted income stream which would be generated. Since the market price depended on that predicted income stream it was reasonable for the sellers to offer some guarantee of that income stream in the form of the warranty payments. The software was acquired at market prices based on reasonable predictions of income. It was not unreasonable, given the significance of the income streams, for the vendors to guarantee the income.

336. To the extent that the question of whether a trade was carried on with a view to profit can be asked at the level of either Daarasp or Betex (rather than its members), a trade was carried on; the evidence demonstrates that the software was developed to be in good working order and development continued on the software. There were good commercial reasons why the software owned by both Daarasp and Betex did not achieve its potential, despite genuine attempts to find alternative markets for the software.

337. Mr Thornhill stressed that the question as to whether a "trade was carried on commercially and with a view to profit" was not relevant to the question of whether Daarasp or Betex were trading at the partnership level. That question was only relevant to "sideways loss relief" claimed by the members under s 384 Income and Corporation Taxes Act 1988 ("ICTA 1988"), which was not part of this appeal. In his view the "commercially with a view to profit" test at s 384 is a discrete test and not part of the general test for whether an entity, including these two partnerships, should be treated as trading.

HMRC's arguments

Daarasp

Did the transactions described by the Appellant during its first two accounting periods actually occur?

338. HMRC put the Appellants to strict proof to demonstrate that the transactions which they say took place did in fact occur. HMRC dispute that the evidence provided by Mr Makhdumi in the form of the "trade transaction reports" actually shows that the Daarasp Software was used for these trades. It is not clear that the trade transaction report refers to trades undertaken on the NYSE.

339. Equally the invoice provided from 1Ecomnet to Mr Makhdumi and Parjun Enterprises of 31 March 2004 on behalf of Daarasp is vague on its face about what the payment is being made for, despite the fact that payment is directed to be made to Daarasp's bank account.

340. As for the functionality of the Daarasp Software in March 2004, Mr Sykes was provided with a CD which was described (by the Appellants) as including the 2004 version of the Daarasp Software which had been held in escrow. Mr Sykes' version of the CD was not corrupted or incomplete, but in his expert view, it was not functional.

341. Mr Sykes should not be criticised for failing to take account of the 2006 "re-established" software since it is far from certain that this represents the original 2004 Daarasp Software, particularly since it is written in a different coding language.

Daarasp and Betex

342. HMRC's position is that, viewed realistically, neither Appellant carried on a trade. Their acquisition of the software licences was merely a necessary element of arrangements intended to generate a loss through the capital allowance legislation.

343. Ms Nathan referred us to the approach which the authorities suggested should be taken to determine whether a trade was being carried on, taken from *Arrowtown* and *BMBF*:

> "The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically" Ribeiro PJ at [35] of *Arrowtown.*

344. She referred us to the approach to the characterisation of transactions following the *WT Ramsay Ltd v IRC* line of authorities set out by Lewison J in *Berry v HMRC* including as number eight of the fourteen suggested conclusions that:

> "It is not an unreasonable generalisation to say that if Parliament refers to some commercial concept such as a gain or a loss it is likely to mean a real gain or a real loss rather than one that is illusory in the sense of not changing the overall economic position of the parties to a transaction"
>
> and at number 10:
>
> "In approaching the factual question whether the transaction in question answers the statutory description the facts must be viewed realistically" [31]

345. In HMRC's view, the Tribunal are required to stand back and look at all of the activities carried on by the Appellants as suggested in the *Eclipse* decision:

> "It is necessary to stand back and look at the whole picture and, having particular regard to what the taxpayer actually did, ask whether it constituted a trade" [111]
>
> and similarly
>
> "The reality of the transaction is something quite different. It requires a detailed factual investigation of what actually happened and what the taxpayer actually did"[114]
>
> and finally
>
> "What is necessary is an evaluation of the precise facts against the background of the meaning of the statute" [148]

346. This is the approach which was accepted by Henderson LJ in *Samarkand*:

> "The question whether what the taxpayer actually did constitutes a trade has to be answered by standing back and looking at the whole picture.... Although it is a matter of law whether a particular activity is capable of constituting a trade, whether or not it does so in any case depends upon an evaluation of all the facts relating to it against the background of the applicable legal principles.....The exercise which the FTT has to undertake is one of multi-factorial evaluation, and their conclusion can only be challenged as erroneous in point of law on *Edwards v Bairstow* grounds" [59]

347. Adopting this approach, HMRC say that the evidence provided does not support a conclusion that either Daarasp or Betex were trading; both of the LLPs were essentially passive, relying on technical support from others and were not directly involved in the exploitation or distribution of the software which had been acquired.

348. The Appellants took little part in the development or exploitation of the Daarasp or Betex Software licences, having no staff, no customers of their own and undertook no activities to exploit the software.

349. There was a lack of due diligence over the Software licences which were acquired and no independent assessment of their market value, suggesting that the Appellants were not conducting the business in a commercial way with a view to profit.

350. As the notes of meetings of both of the LLPs demonstrated, there was a failure to hold those who were purported to be making business decisions on behalf of the LLPs to account when profits were not generated.

351. After acquiring their Software licences, the LLPs received progress reports and set up members' meetings. Any day to day activities were outsourced to others, the LLPs were not involved in the marketing or exploitation of the Software licences.

352. Ms Nathan argued that the activities of the LLPs were not consistent with transactions being carried on in a commercial manner as would be expected if a real world view of what amounts to a trade was adopted. Ms Nathan accepted that there was no specific statutory reference to the need to demonstrate that the LLP's were engaged in activities "with a view to profit" but suggested that the manner in which the LLPs carried on their activities was relevant in deciding whether those activities amounted to trading.

353. She referred us to the decision in *Patrick Degorce* and the explanation given in the *Seven Individuals* decision by Nugee J of what it meant be carrying on a trade on a commercial basis:

> "a trade run in the way that commercially-minded people run trades. Commercially minded people are those with a serious interest in making a commercial success of the trade" [46] and

"When assessing whether a trade [is] carried out on commercial lines, the likelihood of profit seems to me to be central to an assessment of its commerciality*"* [54].

354. The *Samarkand* decision made a similar point about "commerciality", referring to the *Wannell v Rothwell* decision:

"commercial and with a view to profit are two different tests but that does not mean that profit is irrelevant when considering whether a trade is being carried on on a commercial basis. The reference in *Wannell v Rothwell* to the serious trader who is seriously interested in profit is not only relevant to deciding whether a person is a serious trader or an amateur or dilettante. We consider that the FTT were right when they said... that the serious interest in profit is at the root of commerciality" [96].

355. Finally HMRC stress that the reference to profitability or the aim of making profits is directed at the LLPs' profits, not any profits which may be generated or expected at the level of the participating partners.

356. HMRC suggested that there were several aspects of the way in which the LLPs undertook their activities which was not in the "commercial manner" of someone carrying on a trade:

(1) The payment for both Software licences was made on day one in a single lump sum, despite the fact that the intermediate entities (Piebet and Damats) only made a relatively small upfront payment to the ultimate sellers of the software and despite the fact that neither LLP was certain that the software was commercially viable.

(2) The Disclosure of Tax Avoidance Schemes, ("DOTAS") notification and the focus in the PMID on the availability of first year allowances suggested that this was the main reason for structuring the payments as a one-off lump sum.

(3) The success or failure of the structure did not depend on the realisation of profits because of the warranty payments, as suggested in the meeting minutes of Daarasp.

(4) Neither LLP did much due diligence or took much time to establish whether the price paid for the software was a fair market price and took no steps to make changes (such as changing distributor) when profits were not generated.

(5) No independent assessments were made of the business plans provided to either LLP and both LLPs failed to seriously consider marketing and sales plans particularly (in the case of Betex) in the face of significant existing competition.

357. HMRC say that the acquisition of the Software licences by both Appellants was simply a necessary element in an arrangement which was intended to generate first year allowances.

358. Applying the badges of trade, referred to in *Marson v Morton*, does not alter this analysis, of the relevant badges of trade only at best two suggest that what the LLPs were doing was trading; the underlying asset could in theory be used for trading and

the type of transactions undertaken to generate fees from the software were not "one off" transactions.

Decision on Question 2 - the Trading question– viewed realistically, did the Appellants carry on a trade?

359. First year allowances will only be available to the Appellants if they can each demonstrate that they were carrying on a qualifying activity under s 11 CAA 2001. The relevant "qualifying activity" for these purposes is a "trade" under s 15(1)(a) CAA 2001.

360. The burden of proof is on the Appellants to demonstrate that they carried on a trade.

361. There is no statutory definition of a trade or what it means to be carrying on a trade but there are many authorities which have considered its meaning in the context of tax legislation. We were referred to a number of recent decisions which considered the question in the context of transactions which generated significant tax benefits through partnership structures, such as the *Eclipse* and *Ingenious* decisions.

362. We have referred to the approach taken in these authorities but always bearing in mind that the question of whether a particular taxpayer is carrying on a trade is primarily a question of fact which depends on the particular activities and specific circumstances of each individual taxpayer:

> *"It is a matter of law whether or not a particular activity is capable of constituting a trade. Whether or not the particular activity in question constitutes a trade depends on an evaluation of all the facts relating to it against the background of the applicable legal principles*" *Eclipse* at [112] Sir Terence Etherton C.

Preliminary points

When do the Appellants need to demonstrate that they are trading?

363. In our view it is clear from s 11 CAA 2001 "*Allowances are available under this Part if a person carries on a qualifying activity and incurs qualifying expenditure*", that the Appellants have to demonstrate that they were carrying on a trade at the time when expenditure on the assets which gave rise to capital expenditure was made. For Daarasp, this is the 26 March 2004. For Betex it is 4 November 2005 and 20 March 2006. This point was explicitly referred to in the *Samarkand* decision in the Court of Appeal:

> "*It is common ground that the question of trading has to be determined at the time of the financial close, when the acquisition expenditure on each film was incurred*" Henderson LJ at [66].

364. S 11 CAA 2001 applies to all allowances granted under Part 2, of the CAA 2001, which includes the first year allowances granted by s 45 and therefore we have

concluded that it is necessary for a taxpayer to demonstrate that he is carrying on a trade at the time when expenditure is incurred. It is not sufficient to demonstrate that a trade was commenced at later date and that the activities which were being carried on at the relevant time were preparatory or preliminary activities.

365. For this reason we have focused on what it was that both Daarasp and Betex could be said to have done by way of trading or trading like activities during the accounting periods when they say they incurred qualifying expenditure on the relevant software. We have considered the evidence which both Appellants provided of activities carried out at later periods only to help us consider the "whole picture" and to the extent that it is indicative of whether either LLP had in place resources and a framework which could support trading activities at the relevant time.

The LLP and its members

366. Several of the cases to which we were referred consider the trading question not in the context of the partnership through which the relevant assets were held, but in the context of the members of that partnership who were claiming losses in their capacity as partners through "sideways" loss relief.

367. Mr Thornhill was anxious to stress, and we accept, that the test for claiming sideways loss relief is a different test than the test which we are applying, in particular it includes a specific reference to trading activities being carried on "*on a commercial basis with a view to profit*" (in s 384 ICTA 1988), which is not referred to in s 15(1)(a) CAA 2001. We also note that the *Wannell v Rothwell* decision, to which we were referred by HMRC, is itself a case considering whether activities were undertaken with a view to profit for sideways loss relief purposes, not a "pure" trading case.

368. For these Appellants the only entity whose activities are relevant is the LLP, which, as a separate legal entity, has to be considered separately from its members; it is the entity which is claiming capital allowances. In the *Ingenious* decision in particular the Tribunal was very careful to stress the distinction between what the actions and motivations of the partnership were compared to the actions and motivations of the partners themselves.

369. We are concerned only with what the two LLPs, Daarasp and Betex did, not what their underlying partners may or may not have done. We have taken as the fundamental question which we have to answer, based on the formulation in *Eclipse***:**

> *Standing back and looking at the whole picture, did what either of Daarasp or Betex actually did, at the time when the expenditure was incurred on the Software licences, amount to trading or an adventure in the nature of a trade*?

The LLP and its "agents"

370. An important related question for us in understanding "what did the LLPs do" is to decide to what extent those who were contracted by the LLPs to undertake activities on

their behalf can properly be treated as agents of the LLP so that their activities should be taken account of in deciding what the LLPs did.

371. In our view this was one of the critical reasons why the Tribunal decided in the *Ingenious* decision that the relevant partnership could be treated as trading:

> "*Through its actions and those of its agents the LLPs engaged in speculative, organised, repeated transactions in a way which involved work beyond that which would have been involved in the mere making of an investment*" [438]

372. In contrast the FTT in the *Eclipse* decision (with which the Court of Appeal agreed) considered that although the partnership entered into service level agreements in order to exploit an asset (film licences in that case) with those who had expertise to carry out the tasks necessary to exploit the asset, the LLP had "*no meaningful part in directing, supervising or marketing*" the asset. In that case the court found that the service providers were not appointed as mere agents of the LLP, but were allowed to prioritise their own commercial interests.

373. For this reason we have scrutinised the Distributor Agreements and other support agreements entered into by both LLPs to decide whether we should take account of the activities of those appointed by the LLPs to undertake specific activities to determine whether the LLPs themselves should be treated as trading.

The general approach to trading

374. Mr Thornhill sought to persuade us that there are some activities which are inherently trading activities; if an activity is of a trading type, it will be a trading transaction, whenever and however carried on. He referred to statements of Lord Templeman in *Ensign Tankers* in the House of Lords that investing in films was "inherently" 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*" at p 680

and suggested that "passive activities" including the exploitation of film rights could amount to a trade. Mr Thornhill also relied on *Tower MCashback* where it was accepted that very similar activities, the acquisition of software licences through limited liability partnerships, were in essence trading activities, (Henderson LJ in the High Court at p701 [19]).

375. It is worth setting out at this stage how we would describe, in broadest terms, the activities of Daarasp and Betex, what the "assets" held by each partnership were and what the "exploitation" of those assets entailed. While the manner in which the rights to the software licences were transferred differed between the Daarasp and Betex Deeds of Agreement, both partnerships owned rights to software licences giving them the ability to exploit that software by allowing customers to pay fees to use it in order to

undertake, in Daarasp's case, on-line equity trades, in Betex's case, on-line person to person betting.

376. We agree that these activities could be trading activities, but we do not accept Mr Thornhill's approach to the activities of Daarasp and Betex as a starting proposition for two reasons: (i) The question of whether a given activity is a trading transaction is inextricably bound up with the circumstances in which that activity is carried on. (ii) It is not enough to simply fit the Appellants' activities into a trade-like compartment, it is also necessary to show that the Appellants were carrying on that trade at the relevant time; the condition in s 11(1) is that "*allowances are available under this Part if a person carries on a qualifying activity and incurs qualifying expenditure*". The test is a qualitative test of what has actually been done.

377. Mr Thornhill's approach was rejected in both the *Samarkand* and the *Eclipse* decisions to which we were referred and set out in *Degorce*:

> "*There is no dispute that such activities are capable of forming part of a trade, and in many contexts the only reasonable conclusion will be that they did form part of a trade. But when the whole picture is examined, the conclusion will not necessarily be the same*" [52] Henderson LJ referring to his own decision in *Samarkand.*

378. Ms Nathan suggested that our starting point should be to stand back and look at all of the activities carried on by the Appellants and ask ourselves whether, by reference to a "real world" test and in reliance on the detailed finding of facts by the Tribunal the Appellants were carrying on a trade. We agree that this is the correct approach.

379. In our view the test of whether a trade is being carried on is one which can encompass a wide range of factors, an approach encapsulated in the concept of the so called "badges of trade". That test, as cited in the *Vaccine Research Limited* decision (derived from *Wannell v Rothwell),* includes considerations of the "commercial framework" of the undertaking, described as "*the difference between the serious trader, who, whatever his short comings in skill, experience or capital, is seriously interested in profit, and the amateur or dilettante"* Walker LJ at [461] .

380. Similar approaches were adopted in the *Eclipse* and *Samarkand* cases and is the approach which we are following here:

> "*The FTT was rightly examining the reality of what was actually agreed and done by Eclipse 35..... looking at the terms of the contractual documents and the persons who were actually responsible for the marketing of the films..... what is necessary is an evaluation of the precise facts against the background of the meaning of the statute*" [146] – [148] Sir Terence Etherton C.

And *Samarkand*:

> "*Although it is a matter of law whether a particular activity is capable of constituting a trade, whether or not it does so in any given case depends on an*

evaluation of all the facts relating to it against the background of the applicable legal principles" [59] Henderson LJ.

381. Mr Thornhill suggested that questions about whether the Appellants were carrying on a trade "*commercially with a view to profit*" are not relevant to the question of whether trading is being carried on at the level of the LLPs themselves, and is only relevant in the context of sideways loss relief for the members.

382. We accept that there is a specific reference to this test in the sideways loss relief rules, but we do not accept that this means that considering whether activities are carried on in a commercial manner is not relevant to the question of whether the Appellants were trading. Authorities considering the meaning of "trading" in this context and the badges of trade themselves indicate that a profit making motive and whether the framework of the relevant activities is akin to a commercial framework, are components of the general test for trading and in our view this is certainly part of the "whole picture" at which we should be looking.

383. Going back to one of the earliest formulations of this test set out in *Marson v Morton*:

> " *In order to reach a proper factual assessment in each case it is necessary to stand back, having looked at those matters, and look at the whole picture and ask the question - and for this purpose it is no bad thing to go back to the words of the statute - was this an adventure in the nature of trade? In some cases perhaps more homely language might be appropriate by asking the question, was the taxpayer investing the money or was he doing a deal*?" p 471

384. In our view the question of whether a trade is carried on a commercial basis with a view to profit is a component of the general test for trading, underlying the question of whether a "deal is being done".

Alternative characterisation

385. In some of the authorities to which we were directed, having concluded that the relevant entities were not trading, the courts went on to describe what it was they considered the partnerships were actually doing: In the film sale and leaseback cases the obvious alternative characterisation is investment not trade (as in the *Samarkand* decision), in cases, such as *Eclipse*, where the acquisition of film rights gave rise to more than a mere income stream being transferred, the court concluded that the partnership was engaged in a "non-trading business". Many of the case authorities, including *Marson v Morton*, are also engaged in considering not simply whether an activity is trading, but also whether, in contrast, it is an investment activity.

386. In our view it is not relevant to our decision on the question of whether the LLPs were trading that we should be able to identify, if they were not trading, what it was that they were actually doing. The onus of proof is on the Appellants to demonstrate that they were trading, there is no obligation on HMRC or this Tribunal to come up with an alternative explanation of what was being done if we conclude that they were not trading.

DAARASP

387. The evidence which we saw and heard about Daarasp's activities at the time when the qualifying expenditure was incurred on the Daarasp Software licence in March 2004 has not persuaded us that Daarasp was carrying on a trade.

The activities of Daarasp before March 2004

388. On the evidence which we saw, Daarasp was set up on 15 March 2004 and owned no assets and carried out no significant activities prior to its acquisition of the Daarasp Software licence on 26 March 2004. Neither party suggested that any of its activities prior to the acquisition of the Daarasp Software licence should be taken account of to determine whether or not Daarasp was trading.

The activities of Daarasp after it acquired the Daarasp Software licence

389. At or around the date when Daarasp acquired the Daarasp Software licence it also entered into a number of other agreements:

(1) It entered into an agreement with DCC on the 25 March (the day before it acquired the Software licence) obliging DCC to provide the hardware on which the software was run and to provide technical support for the software.

(2) It entered into two distributor agreements, one with Mr Makhdumi and one with Mr Curchod, agreeing that Daarasp would act at the direction of the distributors or their customers to route services to the distributors' clients.

(3) It entered into the suite of financing documents.

(4) It entered into an option agreement with Parjun Enterprises giving that entity the right to buy back the Daarasp Software licence from 26 March 2005.

(5) A few days later, on 29 March, acting through Mr Hargreaves (with no reference to the other members) it agreed to the carving out of the Australasian rights from the scope of the Daarasp Software licence.

390. Those agreements effectively ensured that all of its core activities, the maintenance of its only commercial asset and the exploitation of that asset, were outsourced to other parties. All that remained for Daarasp to do was to provide oversight of how these agreements were implemented. The only aspects of Daarasp's activities which were not outsourced were its financial obligations.

391.We have already made a finding of fact that, at best, at the time when Daarasp acquired the Daarasp Software licence, the software was capable only of very restricted functionality and if it could function at all, it could only do so in reliance on a broker to provide access to the relevant exchanges. We saw no evidence that at this time the Daarasp Software was capable of fulfilling the description given of it in the Deed of Agreement under which the software was purchased, which described it as;

> "*An integrated system..... that delivers information, data analysis and decision analytics and provides the quickest execution for financial traders*"

392. On that basis the Daarasp Software licence was not an asset which could be exploited to generate profits to any meaningful extent.

393. This is reflected by the fact that the only activities which were carried out at this stage were minimal and did not include exploiting the Daarasp Software to undertake any live equity trading. Any profits generated were small, particularly when considered in the context of the amount which had been paid for the Daarasp Software licence. In its first accounting period from 17 February 2004 to 4 April 2004, in which it had paid £18,188,244 for the Daarasp Software licence, Daarasp generated income of £3,619. According to the bank accounts of Daarasp that income was a payment of fees from the New York entity owned by Dr Shaheen Ahmad, 1Ecomnet.com paid at the end of March 2004.

394. We also saw the invoice referred to by Mr Makhdumi for these fees, but this was not specific about what the payment related to and was addressed to Parjun Enterprises apparently as agent for Daarasp.

395. The list of trades provided by Mr Makhdumi which he said were trades carried out in New York using the Daarasp Software all commenced in May 2004, after the time when Daarasp incurred its qualifying expenditure and after the end of its first accounting period. In any event the list of trades which we saw had nothing to associate them with the Daarasp Software other than Mr Makhdumi's statement that they had been provided to him by Dr Shaheen Ahmad.

396. The only other income which Daarasp generated during this period arose from the warranty payments. Mr Thornhill suggested that these should also be treated as trading income.

397. Under the Deed of Agreement between Damats and Daarasp, Damats warrants, at Schedule 4 that the Software licence will yield a minimum net operating income per quarter and an additional amount over the full term of the licence. As a commercial matter, any actual payments under that Schedule could be made only on the basis that there had been a breach of those warranties because the warranted income had not been generated by the Daarasp Software in the relevant quarter. We did not see any evidence of how any claims under those warranties were actually made, but we did see the warranty payments in Daarasp's bank accounts.

398. In our view, given that the warranty payments were payable in circumstances in which Daarasp had failed to reach its agreed operating income targets, the better view of their character is as compensation for a failure to generate trading income, rather than as a reward for trading as such. The source of those payments is the Deed of Agreement, not the trading activities of Daarasp.

399. We do not accept that the warranty payments should be taken account of in analysing Daarasp's trading income either at the time when the Daarasp Software licence was acquired or in its first short accounting period.

400. It might be said that it is unreasonable to expect that Daarasp should be undertaking any significant trading activities in this, its first very short accounting period. While we

accept that this minimal level of activity could have represented the type of activities to be expected of a "start up" entity in this market, we have misgivings about accepting this as an explanation for Daarasp's lack of activity in the period because:

(1) There is significant doubt whether the asset on which Daarasp was relying to generate its profits, either in this period or future periods, was a viable asset and it was certainly not an asset of the quality described in the Deed of Agreement. It is hard to understand how Daarasp could have been unaware of that fact if it was seriously engaged in turning this asset to account, particularly having paid more than £18 million for it. On that analysis Daarasp had not even got to the "start-up" stage at this point, it was at the development stage at best.

(2) Bearing in mind that the test in s 11 CAA 2001 applies to the time at which the qualifying expenditure on the relevant asset is incurred, even if we do consider Daarasp's activities for later accounting periods, to the extent that this may indicate that Daarasp should be treated as in "start up" mode for its first accounting period, we know that Daarasp's profits did not increase significantly in its next accounting period; the majority of its income for that period also came from warranty payments, with only £9,433.00 derived from sales income. As in the first period, that trading income was from Parjun Enterprises in Pakistan and 1Ecomnet in New York.

The commercial framework of a trade

401. Taking account of Mr Thornhill's argument that the question of whether a trade was being carried on "commercially and with a view to profit" is not a specific test in the context of the LLP's activities, we are nevertheless considering the general commercial framework of Daarasp's activities as indicative of our obligation to look at the whole picture because, as we have explained, we think that the commercial framework of a business is indicative of the character of its activities:

(1) Daarasp did not demonstrate to us that it had the kind of serious infrastructure (both in terms of human capital and hard resources) which would have indicated that it was carrying on a trade. While those witnesses who we heard from who were involved with Daarasp gave different explanations for why significant profits were not made, they were strikingly similar in their attempts to distance themselves from the decision making processes which were fundamental to the business of Daarasp, such as the way in which the Daarasp Software licence was valued or how the geographical split to which the licence applied was determined.

(2) In particular Mr Hargreaves, despite his role as Managing Partner of Daarasp explained his role as more of an administrator than a decision maker "*to make sure that the arrangements were carried out, that the cash flows and contract flows happened and the partners got what they expected*" making it clear that he had no expertise in IT software and relied on Mr Curchod for his expertise.

(3) Few actions were taken by anyone who represented Daarasp during this period to ensure that it was on track to generate the profits which it was intended

to generate and we have been left wondering who was in fact the leading mind and decision maker on behalf of Daarasp. No meetings of Daarasp members were held at all until September 2004 and that was poorly attended by only seven members plus Mr Hargreaves and Mr Makhdumi. The "Milestone document" which Mr Makhdumi referred to was a brief overview document which did not to us seem to be consistent with the acquisition of a business asset as valuable as the Daarasp Software.

(4) The LLP members were informed of Daarasp's activities in the members' meetings of 24 February 2005 and 1 September 2005; In the September meeting the four attending members were told "*The Chairman confirmed that the LLP was profitable due to the level of warrantied income proving the robustness of the structuring*", Mr Makhdumi said "*the existence of competition meant that the LLP had under-achieved against forecast*", but no queries, comments or suggestions were made.

Did Daarasp carry on trading activities through others?

402. It might be suggested that Daarasp's activities were properly outsourced to those who had a better understanding of the business, Mr Makhdumi, Dr Shaheen Ahmad and Mr Curchod at the time when it entered into the distributor and other support agreements when the Daarasp Software licence was acquired. While it is true that there is no reason in principle why a trade cannot be carried out through agents, the evidence which we saw did not support a conclusion that Daarasp was trading through those to whom it "outsourced" its activities.

403. Daarasp entered into a number of support agreements relating to the Daarasp Software:

1. The Support Agreement with DCC, signed on 25 March 2004 under which DCC agreed to "*use its best endeavours to provide technical support for the software*".

2. Two Distributor Agreements entered into by Daarasp – one with Mr Curchod, signed on 26 March 2004 and one with Mr Makhdumi and Dr Shaheen Ahmed signed on 26 March 2004. Both are brief and merely state that "*Daarasp has agreed to provide such services to the Distributor or at the direction of the Distributor to the Distributor's ultimate customers and to route the service as required by the Distributor*".

404. A few salient points about these agreements:

(1) None of them specifically appoint the counterparty to be the agent of Daarasp.

(2) All were signed very shortly before or very shortly after the Daarasp Software licence was acquired and the partnership set up, with no evidence that anyone at Daarasp scrutinised them or negotiated their terms.

(3) Other than the short lived Distributor Agreement with Mr Curchod, they all entailed transferring responsibility from Daarasp back to those who were originally the owners or developers of the Daarasp Software, with no obvious opportunity for Daarasp to either add value in the day to day exploitation of the Daarasp Software licence or any evidence that the activities of those to whom these tasks were delegated were scrutinised.

(4) Ironically, the only person who appeared to us to have a real understanding and interest in Daarasp's business, Mr Curchod, told us that he felt he was intentionally kept away from the business; his three month Distributor Agreement (for the UK and Ireland) ended after its initial three months because the Daarasp Software did not have the functionality he needed to be able to sell it to trading desks in London and when he took an interest in Mr Makhdumi's business in Pakistan "*he was kept at a distance because he asked difficult questions and challenged some of Mr Makhdumi's decisions".* Mr Curchod also said, quite rightly in our view, that the business plan for Daarasp was confused and insufficiently detailed.

(5) One would expect some degree of oversight of those to whom core activities have been transferred if activities are to be part of a proper trading operation. We saw no evidence of any such oversight, least of all through the Daarasp membership meetings.

405. In our view the evidence does not support a conclusion that Daarasp had any oversight of these delegated arrangements or indeed any role in any meaningful exploitation of the Daarasp Software licence once these agreements had been entered into. The nature of these agreements plus the existence of the buyback option with Parjun Enterprises suggest to us that Daarasp was little more than a passive conduit, through which those who had originally owned the Daarasp Software exploited it and were given the opportunity to reacquire it.

406. We have concluded that Daarasp cannot be treated as trading though these third parties.

Did Daarasp have a trading strategy?

407. It is obviously not sufficient proof that Daarasp was not trading to point to the fact that minimal profits were generated in the accounting period in which the Daarasp Software licence was acquired or subsequent periods, but our view is that the inconsistent explanations from those involved about the main target markets for the Daarasp Software, the lack of a clear marketing strategy and conflicting views of the long term strategy for the business adds force to the conclusion that Daarasp's internal organisation was not consistent with an entity which was set up to focus on trading activities.

408. As Mr Curchod pointed out, there was confusion about what the real market for the Daarasp Software actually was and a lack of oversight of the development of the Daarasp Software in Pakistan and the US; Mr Curchod thought the main market should be hedge funds, Mr Makhdumi viewed the main market as day traders.

409. None of those involved seemed to have understood the potential issues with accessing the Karachi and New York stock exchanges, whichever market they were aiming for. Mr Edmond explained Daarasp's low profitability as due to the problems with accessing the Karachi stock exchange, Mr Makhdumi blamed the Karachi stock exchange crash and the later global stock market crash.

410. This lack of a proper commercial attitude to Daarasp's business is best demonstrated by the manner in which the Daarasp Software licence was valued at the time when it was acquired. Bearing in mind that this was Daarasp's only asset and the core of its profit making structure, it is hard to understand why so little effort was expended in ensuring that it had been properly valued or why no questions were raised about the valuation by anyone at Daarasp, including Mr Hargreaves.

411. None of those who were involved in valuing the Daarasp Software licence were experts in the valuation of software and all relied on other sources as the basis for their valuation conclusions. Even those who were involved described the valuation process as "rough and ready". Mr Edmond, who produced the valuation, although he of course was not a member of Daarasp, said that it was "*done on the back of an envelope at the time*" and had been based on the TSZ Web document by reference to a 5 % growth rate which he could not explain.

412. Mr Hargreaves also suggested that the valuation had been produced under pressure of time because of the need to get the deal done and that it was driven by the £1.4 million which Mr Makhdumi said he needed.

413. Mr Curchod appeared to us to be the only person involved who had any real expertise in this area. He was circumspect about the valuation of the Daarasp Software licence and in fact said that his estimated profit figures for it would have been higher than Mr Edmond's.

414. Mr Thornhill suggested, correctly, that there was no "objective" right value for the Daarasp Software licence and that the test was not whether a reasonably correct valuation was ascribed to the software, but whether those involved genuinely believed that it was worth what they had been told.

415. The problem with this approach is that it is simply shifting the question to a different level. A genuine belief, must, in our view, be based on some genuine facts or understanding. There is no evidence that those, such as Mr Edmond and Mr Hargreaves, had any such basis for a genuine belief. They might have had a basis for wanting to believe that the Daarasp Software licence was worth what they said it was worth, but that is best described as wishful thinking if it is not based on known facts or an understanding of how software should be valued.

416. If further support is needed for this rather un-businesslike approach to the valuation of the Daarasp Software licence, the manner in which the consideration paid by Daarasp was reduced at the last minute, with no reference to the members, by carving out the Australasian rights, with only a very high level justification for allocating 28% of the price by reference to a geographical split, is a further indication that what should have been the core question for the Daarasp business; the valuation of its only asset, was not considered in a rigorous or businesslike manner.

417. In our view the only person with a real incentive to understand the actual value of the Daarasp Software licence was the original seller, Mr Makhdumi and it is relevant in our analysis that the only payment which he actually received for the Daarasp Software was the upfront sum of £1.4 million which was paid to him on day one.

The badges of trade

418. We have left until the final stage of our analysis an application of the so called "badges of trade" applied in the *Marson v Morton* decision to Daarasp's activities at the relevant time. We are not treating the badges of trade as providing a definitive answer to the question of whether Daarasp can be treated as trading, but more as a cross-check to indicate whether the conclusions that we have already drawn are consistent with an analysis based on the badges of trade. This is mainly because in our view the badges of trade are not cast in terms which make them readily applicable to the type of activities alleged to have been carried out by Daarasp.

419. Some of the nine badges of trade set out in the *Marson* decision are not relevant to Daarasp's activities; whether the asset sold was divided into saleable lots and whether it gave rise to any pride of possession. We have ignored these two badges.

420. Of the seven remaining heads:

(1) *One-off transaction*: Our conclusion is that Daarasp did not exploit the Daarasp Software licence to carry out any live trades in the relevant accounting period in which it incurred the qualifying expenditure. We have accepted that a small number of trades were carried out utilising the Daarasp Software licence in its later accounting period which were not "one-off" transactions.

(2) *The subject matter of the trade*: The exploitation of a software licence clearly can be a trading transaction and we have accepted this point.

(3) *The manner in which the activity was carried on*: Were the activities carried on in a way which was typical of trades of this type? We were not provided with any evidence of how a trade in the exploitation of software licences would usually be carried on, but we do think there are some unusual features in the way in which the Daarasp business was organised compared to any normal business; while the Software licence was ostensibly put within the business framework of the Daarasp partnership and subject to various agreements for their exploitation, we have concluded that in substance the way in which the Daarasp Software licence was dealt with by Daarasp itself was not consistent with a typical trader

undertaking this kind of activity. A well organised business with well defined strategies suggests trading activities; both were absent in this case.

(4) *Loan financing*: Daarasp did obtain the full sum paid for the Daarasp Software licence from its members, it did not itself enter into any loan financing (although the members did). Therefore there was no financial imperative to exploit the software licence which might suggest a trading transaction.

(5) *The intention to sell the asset*: In the context of a software licence, we think this test is best formulated by reference to an intention to exploit rather than sell the asset. Consistent with our analysis about the manner in which Daarasp carried on its business, we have found it difficult to conclude that Daarasp took any significant steps to exploit the Daarasp Software licence by deriving fees from equity trading transactions.

(6) *Was work done on the asset to enhance it for sale*? Ms Nathan suggested that this was not a relevant head, but we do not agree. We know that further development was required to the Daarasp Software to make it viable at all and to keep it up to date. Crucially, the commercial agreements gave that responsibility not to Daarasp but to DCC and (under the Warranty Agreement) to Mr Makhdumi and Dr Shaheen Ahmad. If work was required on the asset, Daarasp did not have the knowledge or capacity to do that work. Daarasp was not in a position to enhance the value of the Daarasp Software licence and if that was done, it was not for the purpose of Daarasp exploiting it. This does not indicate a trading activity.

421. The application of the badges of trade, with at best two indicating that Daarasp was undertaking trade like activities, support our conclusion that Daarasp was not carrying on trading activities at the time when it acquired the Daarasp Software licence.

422. There is one additional criterion which was considered in the *Ingenious* decision; whether the activities included the element of speculation or risk which would usually be associated with trading transactions, referring to Millett J's statement in *Ensign* describing "*the speculative hope of profit as indicative of trade*".

423. Applying this test at the time when the qualifying expenditure was incurred, while the Appellant has suggested that there was a genuine belief in the value of the software licence and in the market opportunities for the exploitation of the Daarasp Software licence, our view is that the inclusion of the warranty payments as part of the commercial arrangements strongly suggests that Daarasp was taking no real commercial risk in its acquisition of the Daarasp Software licence. The warranty payments put it in a situation in which it had a guaranteed income, however well or badly the Daarasp Software actually performed in the market. Daarasp does not satisfy this criterion.

Final conclusion

424. For these reasons we have concluded that Daarasp was not carrying on a trade throughout its accounting period from 17 February 2004 until 5 April 2004 March or

specifically on 26 March 2004 at the time when qualifying expenditure was incurred on the Daarasp Software licence.

425. For the avoidance of doubt, we have also concluded that Daarasp cannot be treated as trading in the subsequent accounting period, 6 April 2004 to 5 April 2005.

Betex

426. Our analysis of Betex starts from a more promising position, it was not disputed that the Betex Software was operational in late 2005; Betex did have an asset which could be turned to account to generate profits. Nevertheless, we have concluded that the activities which were carried out by Betex at the time when the two tranches of qualifying expenditure were incurred on the Betex Software on 4 November 2005 and 20 March 2006, and during its accounting period (from 19 February 2005 until 5 April 2006), do not amount to trading activities.

The activities which were carried out in the relevant accounting period

427. The first tranche of payment for the Betex Software was made on 4 November 2005. At or immediately after that date, Betex entered into a number of agreements:

(1) A Support Agreement with IGS New Zealand under which that entity was to provide technical support for the Betex Software.

(2) Two distributor agreements – one with IGS UK and one with IGS New Zealand under which Betex agreed to provide services to the Distributors' customers and route services as required by the Distributors on the Distributors' hardware and accepting that the Distributors were responsible for the day to day running of the operation.

(3) The option agreement with EMG giving it the right to buy back the Betex Software from 1 November 2006.

(4) The suite of financing documents.

428. Other than the responsibilities which it retained under the financing documents, in our view the overall effect of Betex signing these documents was to outsource all of its responsibilities for the core elements of its business to others, resulting in it having no meaningful responsibilities itself other than the oversight of these agreements.

429. Despite the fact that the Betex Software was functional, all of the witness evidence which we heard agreed that it had very limited functionality at this stage and it was used only for "minor runs" of on-line betting transactions. Mr Edmond described the Betex Software as not working because it had not been fully developed in November 2005, Dr Castell said "*the basic functionality was there*" and Mr Sykes described it as in

"*prototype form*" during this period and referred to the fact that it could not be fully operated because it had no software to allow for banking transactions.

430. According to Mr Edmond even by May 2006 the Betex Software was still not fully functional.

431. We saw no evidence that the Betex Software was providing the performance which was described in the PMID at any time from November 2005 when the first tranche of payment was made until March 2006: "*EMG's goal is to provide the most scalable and reliable betting platform available. Betex LLP will use the Software in its trade to provide reliable betting exchange services to the users of the software*"

432. Mr Lee said that profits of £1,995.76 had been generated by him making bets using the Betex Software during this period, but the evidence of this which he provided was a bank statement from July 2008 showing a repayment of funds to him of £6,995.

433. The income generated from fees compared to the level of income derived from warranty payments is made clear in Betex's accounts for this period, (19 February 2005 to 5 April 2006) with fee income of £5 being dwarfed by the very large warranty payments of £1,193,591.

434. The activities which were carried out were through a partner betting establishment in the UK, as we know from Mr Edmond.

435. As a result, the income generated from the Betex Software licence during the period was described by Mr Hargreaves as "modest", referring to the £423.37 recorded by IGS in their presentation in May 2006 as the results from its second month of trading. We would describe that income as minimal, particularly in the context of the amount which had been paid for the Betex Software licence.

436. As for Daarasp, the majority of the income generated by Betex during the period arose from warranty payments.

437.The arrangements governing the warranty payments were essentially the same for Betex as for Daarasp. Schedule 4 of the Deed of Agreement of 4 November 2005 set out the warranties by the seller that the Betex Software licence would yield a minimum net operating income per quarter and a further sum over the life of the licence.

438. Without setting out those reasons again in detail, we have concluded as we did for Daarasp, that the warranty payments cannot be properly treated as trading income during this period.

The commercial framework of a trade

439. In our view, the commercial framework within which Betex operated was thin, particularly bearing in mind the value of the asset which the partnership had acquired. From the evidence which we heard we have concluded that none of those involved in the Betex structure had any direct involvement with its core business, the exploitation

and development of the betting software, which continued to be done by Mr Earle through IGS, (as it would have been done had Betex not been involved). Mr Earle himself told us that despite the fact that Betex had an exclusive licence over the software, his company (IGS) remained the entity which distributed and promoted the software and this is supported by the presentation which was made to Betex about the software at the members' meeting of May 2006.

440. No-one who was a member of Betex added any value to this process as far as we have been able to deduce, despite the fact that the software had been sold to Betex. Both Mr Edmond and Mr Hargreaves distanced themselves from the commercial decision making process at Betex, including the commercial agreements to buy the software and the marketing activities to clients. Mr Edmond said that he was not competent to go and find markets for the product and Mr Hargreaves said that he understood that the exploitation of the software would be done by IGS because they had a commercial interest in exploiting it.

Did Betex carry on its activities through others?

441. Again, it might be suggested that it is perfectly legitimate for a trading entity to run its business by contracting out its core activities. We accept this as a proposition but do not accept that having contracted out its core activities an entity properly engaged in generating profits from its core assets would not have done significantly more than Betex did to provide oversight and management.

442. Betex entered into two support agreements concerning the Betex Software licence, the Distributor Agreement entered into with IGS Limited UK on 4 November 2005 and the Support Agreement entered into with IGS New Zealand dated 4 November 2005. As in the case of Daarasp, these agreements were entered into on the same date that the Betex Software licence was acquired and the date when the Partnership Agreement was entered into. We did not see any evidence that these agreements were the subject of negotiation by anyone at Betex, in the way in which we would expect significant commercial documents to be negotiated.

443.The UK Distributor Agreement with IGS UK was in terms almost identical to the terms of the Daarasp distributor agreements. The Distributor is not appointed as an agent for Betex and agrees to "*provide such services in conjunction with the Distributor to the Distributor's ultimate customers and to route the services as required by the Distributor on hardware provided by the Distributor*" in addition (and unlike the Daarasp Distributor Agreements), in this agreement "*The Distributor shall be responsible for the day to day running of the operation and the obtaining of any betting or gaming licences required in any of the territories in which the services are provided to end users by the Distributor*".

444. The Software Support Agreement entered into with IGS New Zealand on 4 November 2005 merely stated that it was the obligation of the IGS to provide "*technical support for the Software*". Clause 9 of the agreement specifically precluded IGS acting

as agent or nominee for Betex and using the Software other than to fulfil its obligations under the agreement.

445. Some salient facts about those agreements in the light of the conclusions drawn particularly in the *Ingenious* decision about agents acting on behalf of partnerships to carry on trading activities:

1. We saw no evidence of any negotiation by anyone at Betex of these agreements or of how any oversight of the delegated tasks would be managed, particularly given that those to whom these activities had been delegated had much greater expertise than anyone at Betex.

2. None of the agreements specifically appoint the counterparty to be the agent of Betex. These agreements entail transferring responsibility from Betex back to those who were originally the owners or developers of the Betex Software, with no obvious opportunity for Betex to either add value in the day to day exploitation of the Betex Software licence or any evidence that the activities of those to whom these tasks were delegated were scrutinised.

446. This lack of oversight and management of Betex's activities is exemplified in a number of other ways; the fact that members meetings were held infrequently, that no questions were raised about the low levels of profits generated at the start of the activities and no consideration was given to making any changes in the business structure to try and improve the situation.

447. We saw the notes of the member meetings which were held in later periods (May and December 2006 and July 2007). The management accounts for the year to April 2006 were presented at the May 2006 meeting but no action seems to have been prompted by the small profits which had been generated. At that meeting a progress report was given on behalf of the Distributor (IGS) by an IGS employee, stating what IGS was doing to exploit the software and with no evidence of any in-put or oversight from Betex.

448. In our view the evidence does not support a conclusion that Betex had any oversight of these delegated arrangements or indeed any role in any meaningful exploitation of the Betex Software licence once these agreements had been entered into. As we concluded for Daarasp, Betex appears to us to be little more than a conduit through which those who originally owned and developed the software could continue to exploit it while having the right to re-acquire it through the buy-back option.

449. We have concluded that Betex cannot be treated as undertaking trading activities through those to whom its activities were outsourced.

Did Betex have a trading strategy?

450. We have concluded that Betex did not have a commercial strategy consistent with a business-like framework for undertaking its activities. There are a number of indicators of this:

451. The fact that the change in the US gaming laws, which apparently had such a devastating impact on Betex's business seemed to take everyone at Betex by surprise, as did the fact that its main competitor, Betfair, put a "wall of money" into its own advertising, suggests to us that a proper business strategy and management were lacking.

452. This is particularly so given the fact that both of these problems were clearly raised in the MECN memo of March 2004 which the Appellant's witnesses suggested was one of the basis on which the Betex Software licence was valued at £65 million. That memo stated clearly at section 8

> "*The result of this development will be a market where a few players dominate and new entrants will have a rather difficult time*"
>
> and at section 10 "*Consult local law and lobbying experts so as to be prepared for difficult and lengthy legislative developments*".

453. There are two possible conclusions to be drawn from this; either the MECN memo was not properly read, or if it was read, the risks set out were not considered seriously as part of the business strategy by anyone involved at Betex.

454. If everyone at Betex was taken by surprise by this, its distributor was clearly already aware of the issue; the presentation which it made to Betex in May 2006 included as "news" –

> "*Fubet.com [the trading name under which the Betex software was used] will specialise on a number of key sporting events around the world. Fubet.com is not available to US residents at this stage due to restrictive online gaming laws in the US*".

455. The most telling indication of activities not being run in a business like way is the contradictory and conflicting views of those involved with the "end game" for the Betex Software licence, from the suggestion from Mr Earle that he wanted to buy the asset back (effectively preventing Betex from continuing to carry on these activities) and undertake an IPO to the suggestion from Mr Edmond that the aim was for Betex to be a "thorn in the side" of Betfair who would then buy Betex.

456. Finally, and crucially, just like Daarasp, no one involved in Betex was competent to provide a market value of its core asset, the software licence. That valuation was done by Mr Edmond at Charterhouse who said he had no experience in this market and relied on information from third parties to support his conclusion. Despite this, no one suggested that any independent third party valuation of the software should be undertaken.

457. Nor could anyone explain why it had been considered feasible to invest in software for a 25 year period in a market in which there was a real risk that technological change would seriously diminish the value of the software over time.

458. This less than rigorous approach to valuation is reflected in the way in which the division between the first and second tranche of investment in the Betex Software licence was determined, which Mr Edmond described as a mechanism for dealing with a situation in which no further funds were raised. In our view this suggests a valuation which is driven by the amount of investments available rather than by the commercially established price which would be expected in a trading transaction.

459. Again, we do not dispute that those involved believed that the Betex Software licence had some commercial potential, but we do not accept that they had any basis for a "genuine belief" that it was worth the value ascribed to it. It appears to us that the only person who had a real incentive to understand the value of the Betex Software licence was Mr Earle. We were told that he viewed it initially as worth more than the £65 million price put on it by Mr Edmond, but nevertheless he agreed to receive an up-front amount of only £1.8 million and agreed that all other payments should be conditional on profits being made by Betex.

The badges of trade

460. We have left until the final stage of our analysis an application of the so called "badges of trade" as applied in the *Marson v Morton* decision to Betex's activities in its first accounting period. Our approach to their application is the same as we have adopted for Daarasp.

461. Some of the nine badges of trade set out in the *Marson* decision are not relevant to Betex's activities; whether the asset sold was divided into saleable lots and whether it gave rise to any pride of possession. We have ignored these two heads.

Of the seven remaining heads:

(1) *Number of transactions*: We have accepted that a small number of transactions were carried out to generate fees using the Betex Software during Betex's first accounting period and that these are the kind of repeat transactions which may indicate trading activities.

(2) *The subject matter of the trade* –the exploitation of software licences clearly could be trading transactions, as suggested by Mr Thornhill and we have accepted this point.

(3) *The manner in which the activity was carried on* – We were not provided with any evidence about how betting software like this would usually have been exploited. However, even by reference to general commercial principles, our view is that there were some unusual aspects of Betex's business structure. While the software licences were ostensibly put within the business framework of the Betex partnership and subject to various agreements for their exploitation, we have concluded that in substance the way in which the Betex Software licence

was dealt with by Betex itself (and ignoring the activities of those whose services were contracted in under the various service agreements to which Betex was a party) was not consistent with a trader who was seriously pursuing profits. In our view Betex has not demonstrated the kind of well run and organised activities with a clear business strategy which are consistent with trading activities.

(4) *Was there loan financing*? Unlike Daarasp, Betex did obtain some of the funds required to acquire the Betex Software licence in the form of a loan from SG Hambros: £39 million of the £65 million paid for the Betex Software licence was borrowed funds. Loan financing is generally considered to be indicative of trading if the only way in which the loan financing can be repaid is by the sale of the asset. That is not quite the case here; only a percentage of the ostensible value of the asset was borrowed and the amount which was borrowed was guaranteed by Hambros CI effectively protecting Betex from any commercial need to exploit the Betex Software licence in order to pay off its loan.

(5) *The intention of Betex to exploit the Betex Software licence*. Our conclusions about the manner in which Betex's business was carried on must also lead to a conclusion that no one who was involved with Betex had the intention to seriously exploit the software licence.

(6) *Was work done on the asset to prepare it for sale*? Ms Nathan suggested that this head was not relevant to Betex but we are not so sure. We know that the Betex Software, like all software, would require upgrading and technical support both to get it to its full operational capabilities and to keep it up to standard and marketing and business management in order to exploit it to its full capacity.

In our view it is significant both that it was not considered to be a finished product when it was sold to Betex and that it was not Betex, but IGS who was employed to carry out any future technical support of the software. It is also significant that little resource was spent in marketing the product.

Both of these conclusions indicate that Betex was not undertaking work on the software in order to exploit it.

462. The application of the badges of trade, with at best two clearly indicating that Betex was undertaking trade like activities, support our conclusion that Betex was not carrying on trading activities at the time when the qualifying expenditure was incurred on the Betex Software, either in November 2005 or March 2006 or throughout the relevant accounting period.

463. There is one additional criterion which was considered in the *Ingenious* decision; whether the activities included the element of speculation or risk which would usually be associated with trading transactions, referring to Millett J's statement in Ensign describing "*the speculative hope of profit as indicative of trade*".

464. Applying this test at the time when the expenditure was incurred, while the Appellant has suggested that there was a genuine belief in the value of the Software Licence and in the market opportunities for the exploitation of the Betex Software, our

view is that the inclusion of the warranty payments as part of the commercial arrangements strongly suggests that Betex was taking no real commercial risk in its acquisition of the Betex Software licence. The warranty payments put it in a situation in which it had a guaranteed income, however well or badly the Betex Software licence actually performed in the market. Betex does not satisfy this criterion.

Final conclusion

465. For these reasons we have concluded that Betex was not carrying on a trade throughout its accounting period from 19 February 2005 to 5 April 2006 or specifically on 4 November 2005 or 20 March 2006 at the time when the qualifying expenditure on the Betex Software licence was incurred.

466. For the avoidance of doubt we have also concluded that Betex cannot be treated as trading in its subsequent accounting period, from 6 April 2006 to 5 April 2007.

Question 3 - The incurring of expenditure: What level of expenditure did the Appellants incur on the assets for which capital allowances are claimed*?*

Appellants' arguments

467. The Appellants say that they incurred expenditure on qualifying assets; the full value of the software licences was paid to the sellers by Betex and Daarasp. In the case of both Betex and Daarasp, the test of whether expenditure has been incurred as explained by Millett J in *Ensign Tankers* is met:

> "To incur means 'to render oneself liable to'. Expenditure is incurred, whether or not there has been any actual disbursement, if the taxpayer has legally committed himself to that expenditure..... A borrower who obtains a non-recourse loan incurs no personal liability to repay the lender, but this is irrelevant; in the case of borrowed money, s 41 is concerned with the taxpayer's liability to expend it in the acquisition of plant, not with his liability to repay the lender" p 769 [h]

468. They also say that the approach to expenditure considered by the courts in *Tower MCashback* and related cases is not appropriate because in *Tower MCashback* the money for the software licences never got to the sellers, but that is not so here.

469. The Appellants say that the financing arrangements do not impact this conclusion.

The valuation of the Software licences

470. Mr Thornhill accepted that whether market value was paid for the Software licences was one element in deciding whether expenditure was incurred on the qualifying assets, but stressed that it was not required that the Tribunal should establish what the correct valuation of the software acquired by either Appellant actually was.

471. Mr Thornhill suggested that there was no "objective" value which could be ascribed to either Daarasp or Betex's software asset, but the Tribunal merely had to be satisfied that the price paid for those assets was within a "reasonable range of valuations".

472. In the Appellants' view, the consideration paid for the software licences was within the range of reasonable market valuations for the software rights acquired: the sum of £27 million originally agreed for the Daarasp Software licence and the sum of £65 million for the Betex Software licence.

473. In their view, the fact that the amount paid might have been arguably above or below the market value of the Software licences is not fatal to the Appellants' position, as long as the amount paid is within a "range of reasonable valuations" then the expenditure should be treated as incurred on the asset in question.

474. Mr Thornhill suggested that evidence had been provided to support the commercial value of both Software licences; for the Betex Software licence, the Valuation Consulting report was a third party valuation which was supported by Mr Sykes' view that the software was complete and of a high quality. While there was no similar third party valuation for the Daarasp Software licence, Mr Edmond had applied a very high discount to the business plan figures which he had seen to produce a reasonable commercial valuation.

475. If there was a non-commercial aspect of the Software licences, it was only in the length of their terms, at 25 or just less than 25 years, but in both cases Mr Edmond recognised this and produced a valuation which assumed a much shorter, 15 year life.

476. Even if the amount paid for the Software licences could be shown to be outside this reasonable valuation range, it should still be accepted as a genuinely agreed commercial price if the parties honestly and reasonably believed that this was a correct price. The LLPs believed that they were entering into a proper commercial deal when they acquired their Software licences, and HMRC have not effectively challenged this.

477. Mr Thornhill made the following specific points about the valuation of the Daarasp Software licence and the Betex Software licence:

Daarasp Software licence

(1) The experts agreed that there was no standard method for valuing software and that the "lines of code" method used could give a range of valuations. Dr Castell's approach to valuation was supported by Mr Curchod. Mr Curchod's own estimate was that the cost of developing the Daarasp Software was between £4 million and £17 million and that the price put on the Software licence by Mr Edmond was too low. The £27 million valuation placed on the Daarasp Software licence by Mr Edmond was within the range suggested by Dr Castell of between £20 million and £30 million. The valuation done by Mr Sykes relied only on the "lines of code" method, which Mr Thornhill described as a "rather extreme position".

(2) Those who were involved with the Daarasp Software believed that it filled a gap in the market; Mr Curchod was sufficiently impressed to want to invest in it himself and said that it provided something which was not available elsewhere in the market, as his note of 20 January 2004 explains :

> "*The calculations, stochastic processes for example are not new. But what is innovatory is the way the software investors plan to use techniques from the dot.com world to monitor the usage patterns of the investor himself to automatically guide him to the next level of decision making research that will enable him very rapidly to make the deal/no deal decision".*

Mr Lee supported this, describing the Daarasp Software as unique.

(3) This market view, plus Mr Edmond's discounted cash flow valuation and Mr Curchod's views of the build cost and likely utility of the software formed the basis for the LLP's genuine belief that the Daarasp Software licence was worth in the region of £27 million.

Betex Software licence

(4) There was no dispute that the Betex Software was of high standard and functionality as Mr Earle stated; his view was that the software was worth £200 million. The MECN report also provided evidence of the strength of the market for this type of software

(5) The only real difference between the parties was about the proper method for valuing this software. Mr Sykes had conceded that if there was a business plan and strategy for exploiting the software, the Valuation Consulting approach was acceptable.

(6) Mr Edmond's valuation imposed a significant discount on Mr Earle's figures and his approach was supported by the Valuation Consulting report. The valuation provided by Mr Edmond was within the range of values suggested by Dr Castell. Mr Hargreaves was also clear that he believed that the price paid for the Betex Software licence was reasonable on the basis of the information which he saw at the time.

478. The consideration paid for the Daarasp and the Betex Software licences was, in both cases, fair market value. It is unclear what else the expenditure might be said to have been incurred on other than the assets which the Appellants acquired.

479. The option arrangements entered into by Daarasp and Betex show that these were commercial arrangements; the sellers in both instances wanted to be able to buy the software back if it was successful. The proper view of the arrangements is of a joint venture between those who created the software and those who were willing to develop and exploit it: this is supported by the statements of Mr Makhdumi, Mr Curchod and Mr Earle, who said they saw the initial payments made as an injection of cash to get things moving.

The funding structure

480. The Appellants say that the funding structure in both the Daarasp and Betex transactions does not lead to the conclusion that the expenditure was not incurred on the qualifying assets.

481. Unlike in the *Tower MCashback* case, the money borrowed in both the Daarasp and Betex structures did reach the sellers. The capital subscribed by the members of each LLP was used to pay for a software licence in both cases.

482. A proportion of the capital subscribed by the members was used to make initial payments, with £1.4 million being paid to Parjun Enterprises and £1.8 million being paid to EMG. Part of the capital put into the LLPs was used to pay fees and commissions while the rest was retained.

483. The initial cash payments to Parjun Enterprises and EMG got the projects moving, it was a sensible and commercial arrangement for both parties to allow the creators and developers of the software to continue to play a major role in its development with profits being released from the deposit accounts to the developers over time.

484. The facts of these arrangements are not like the facts in the *Ensign Tankers* case, in which Lord Templeman concluded that the non-recourse nature of the lending to the partnerships meant that there was no real liability for the costs of exploiting the films. There was a real financing; Daarasp and Betex were entitled to net profits from the exploitation of the Software licences and owed principal and interest to the lenders under the terms of the Hambros London loans.

485. The deposit with Hambros CI and the warranty payments were part of these commercial arrangements; if the LLPs had made a profit, the loans would have been re-paid and the warranty payments would not have been made. The fact that monies were retained in the Hambros CI account is not relevant to the question of what the expenditure was incurred on or the value of the licences.

486. It was a sensible commercial arrangement for a percentage of the consideration payable to be put on deposit with Hambros CI given the fact that the LLPs were not expected to play a major role in the day to day exploitation of the software, which would be done by the creators of the software. Only when profits were generated through the work of the software creators, would funds be released from the deposit accounts. This represented a balancing of the risks and interests of those involved.

487. The "intermediate vendors" (Damats and Piebet) were required for specific, non-UK tax reasons and should be viewed in that light.

488. It was not necessary for the LLPs to defer their expenditure and await the development of the software, and the fact that all of the payment was made on day one and first year capital allowances were claimed reflects a taxpayer's ability to choose the

most favourable commercial arrangement for tax purposes, see Henderson J in *Tower MCashback*

> "It is by now established that a taxpayer must be taxed by reference to what was actually done and not by reference to some different transaction with the same or similar economic effect" p 725 [83].

489. In any event, if payments had been made in stages, capital allowances would still have been available under s 67 CAA 2001.

490. The arrangements were a joint venture in each case between the creators of the software (Mr Makhdumi and Mr Earle) and the LLPs as investors to exploit the commercially valuable software. The availability of capital allowances to the LLPs was a consequence of this and in line with the intention of the UK capital allowance legislation.

491. The fact that non-recourse financing was provided to fund the acquisition of the assets is not determinative;

> "The mere fact that such a loan is a non-recourse loan, in the sense that the taxpayer is not personally liable for its repayment, the loan being repayable out of property or proceeds in the hands of the taxpayer, will not of itself prevent the transaction from constituting what is in truth a loan, or the expenditure so financed qualifying for a capital allowance" Lord Goff at p 681 *Ensign*

492. Any tax advantages obtained were a natural outcome of the Appellants' investment in information technology and something which parliament intended to be available to those making such investments. By reference to the *Willoughby* decision, there can be no element of tax avoidance when what has been done is in line with the legislation.

HMRC's arguments

493. The Respondents accept that a sum of money was paid by both Appellants in respect of the arrangements to acquire the Software licences and that expenditure was incurred, but say that the expenditure was not wholly incurred on the Software licences. If the Appellants can be treated as carrying on a trade, they have still failed to demonstrate that the expenditure for which first year allowances has been claimed was expenditure wholly incurred on qualifying assets.

The valuation of the software

494. The Respondents say that it is not clear whether the amount paid by either Daarasp or Betex for the software rights which they acquired represented market value or how the projected income from the software licences over their 25 and 24 year terms was established. The Appellants have provided very little contemporaneous evidence of how the market value of the licences was established or how the amounts of annual

income which were projected were arrived at. The Respondents say that the amount paid by both of the LLPs was not the true market value of the software.

495. The Respondents say that the fact that an agreed price was paid for the Software licences does not demonstrate what that price was actually paid for; if more than market value is paid for an asset, any excess must have been paid for something else. This point is made in *Tower MCashback* by Lord Walker:

> *"*I cannot accept that the question of valuation was totally irrelevant in the context of a complex pre-ordained transaction where the court is concerned to test the facts, realistically viewed, against the statutory text, purposively construed*"*[67]

496. The fact that the parties agreed a price for the Software licences does not mean that we should assume that the expenditure was incurred "on" the software (as the *David Price* decision suggests). If more than market value was paid, then any excess over market value must have been paid for something other than the Software licences.

497. Nor is there any evidence that either Betex or Daarasp did any significant due diligence on the Software licences which were being acquired, including to establish their functionality, despite the significant amount paid for them and their purported 24 and 25 year terms; no rigorous tests were done by either entity to establish what the functionality of the software was when it was acquired.

498. In both cases the Appellants paid amounts to the "intermediate" vendors (Piebet and Damats) which were significantly higher than the "initial amounts" paid by the intermediate vendors for the software from the producers and developers of the software. There is a significant mismatch in both the Daarasp and Betex structures between the amounts actually paid by Piebet and Damats to EMG and Parjun Enterprises and the much larger amounts paid only a few days later by Daarasp and Betex. There is no contemporaneous evidence of anyone at either Daarasp or Betex attempting to come to a view about what the correct value of the Software licences might be, despite the fact that they were being acquired, in both cases, from entities which had very little substance.

499. In both the Daarasp and Betex arrangements the amount of expenditure incurred did not go to the seller, but to the intermediate entities, Piebet and Damats, who were not the "true" vendors of the software, but were only included in the structure because they were required by Daarasp and Betex. The "true" vendors were Parjun Enterprises and EMG, both of whom only received a small percentage of the alleged value of the software (in the form of the initial payments made).

500. In HMRC's view it is a realistic view of the facts to conclude that money was expended in order to obtain capital allowances.

The funding structure

501. HMRC say that to determine whether expenditure has been incurred, the financing arrangements entered into by Daarasp and Betex are relevant. That financing had unusual features; guarantees were provided by an associate of the lender rather than

the borrower for example in both cases (from Hambros Jersey and Hambros CI to Hambros London).

502. The amounts which were not paid to the "true vendors" we held in accounts at Hambros which were effectively blocked accounts. As set out in the Deed of Arrangement, both Piebet and Damats signed up to the transaction documents aware of the fact that there would be an onward sale of the software and that funds from that sale would be deposited with Hambros and released only if certain conditions were met. Neither EMG nor Parjun Enterprises had any realistic expectation of receiving any of those deposited funds. Both Damats and Piebet were fully aware that they would never receive the full purchase price of the software. In fact, that money was never paid to Parjun Enterprises or EMG, despite the existence of the Piedama and Dama Trusts.

503. Ms Nathan referred to the Upper Tribunal decision in the *Vaccine Research Limited* case to support her contention that monies tied up in a blocked bank account could not be treated as incurred on trading activities. In the *Vaccine* case a significant amount of the funds invested into a partnership for pharmaceutical research was used to put funds on deposit with a bank which in turned funded a "guaranteed licence fee". This was viewed by the Tribunal as a "self-contained financing arrangement" separate from any genuine trading activity.

504. In conclusion the Respondents say that there is real doubt whether the amounts paid by Daarasp and Betex represented market value for the Software licences which they acquired, and even if that level of payment could be said to have been incurred as the correct price for the software licences, it was not paid to the true sellers, but to the intermediary entities where it was placed in a blocked account.

Decision on Question 3 – the incurring of expenditure: Was expenditure incurred on a qualifying asset by either Daarasp or Betex?

505. Having concluded that neither of the Appellants can properly be treated as carrying on a trade at the time when the qualifying expenditure on the relevant assets was incurred, it is not strictly necessary for us to go on to consider whether that expenditure was "incurred" on the qualifying assets.

506. But we are considering this point in case we are wrong to treat the trading question as under appeal. If we are wrong on that, then the question of whether qualifying expenditure was incurred on a relevant asset becomes the main issue in dispute between the parties.

507. We understood from HMRC that they were not disputing that expenditure had been incurred; they were disputing whether that expenditure had been incurred on the Daarasp or Betex Software licences.

508. On the basis of the evidence which we have seen we have concluded that even if it can be accepted that both of the LLPs were carrying on a trade at the time when the

qualifying expenditure was incurred, only a sum equivalent to the expenditure which was paid to the ultimate sellers, who are the creators and the developers of the software, Parjun Enterprises and EMG, can properly be treated as incurred by Daarasp or Betex on a relevant asset for capital allowances purposes.

509. We were referred to the three leading authorities in this area: *Ensign*, *BMBF* and *Tower MCashback*. We have relied principally on the Supreme Court decision in *Tower MCashback* as the most recent and the most relevant case whose facts are the most similar to those which we have considered. The test for identifying expenditure was encapsulated there by Walker LJ's reference to entitlement to capital allowances requiring

> "there to have been real expenditure for the real purpose of acquiring plant and machinery for use in a trade"

510. The concept of "real expenditure" in the context of an asset financing transaction like these deals done by Daarasp and Betex is a slippery one. To many, a transaction which entails intangible assets being acquired through partnership structures via lending from offshore entities is by its nature outside the real world. Our approach to the authorities, and to *Tower MCashback* in particular, has been to attempt to deduce what the parameters of "reality" are in the context of such a transaction.

511. We take from the *Tower MCashback* decision a number of relevant principles:

> We are required to establish two elements of reality
>
> (a) the reality of the expenditure and
>
> (b) the reality of the purpose of that expenditure.

That decision suggests that in determining what is "real" in this context it is legitimate to look at both (i) the way in which the expenditure is funded and (ii) the way in which value has been placed on the asset acquired.

Reality of the expenditure

512. It is clear that a legal entitlement to the asset is one of the components which determine the reality of an acquisition in a transaction like the ones undertaken by Daarasp and Betex. This underlies the requirement, stressed by Mr Thornhill, that a taxpayer be taxed by reference to the actual transaction undertaken rather than by reference to some economically equivalent but legally different transaction. We have accepted that both Daarasp and Betex had legal rights to exploit the software which was transferred to them under the Deeds of Agreement.

513. But the reality of the expenditure cannot be approached from a purely legal perspective. Part of the need to decide whether "*real expenditure has been incurred for the real purposes of acquiring plant and machinery*" must involve considering whether looked at commercially, the transaction makes sense. In our view, the two concepts are not discrete, in order to decide whether there has been real expenditure, it is important

to consider whether the legal transaction is sufficiently clothed in commercial attributes to make it real.

514. It was this element of commerciality which led Henderson J to accept (in the Court of Appeal) that expenditure had been incurred by the partnerships in *Tower MCashback*:

> "The whole of the purchase price.....was expended by LLP2 on the acquisition of the software, and it was not expended on anything else. The purchase price was negotiated at arms' length between wholly unconnected parties, largely relying on information and projections in the Business Report, which were themselves subject of a limited warranty given by MCashback in the SLA" p 721[72]

Reality of the purpose of the expenditure

515. The purpose of Daarasp and Betex when they incurred the level of expenditure which they did on the relevant assets is also a component of our reality test and was considered in *Tower MCashback*.

516. The way in which the expenditure is funded is relevant to this test. Accepting that the non-recourse nature of a loan does not mean that expenditure has not been incurred; as per Lord Goff in *Ensign*:

> *"*The mere fact that such a loan is a non-recourse loan, in the sense that the taxpayer is not personally liable for its repayment, the loan being repayable out of property or proceeds in the hands of the taxpayer, will not of itself prevent the transaction from constituting what is in truth a loan or, or the expenditure so financed qualifying for a capital allowance. But it is well established in the cases that we should not... have regard to such features in isolation. Indeed the authorities require us to look at related transactions .....as one composite transaction*"*. p681 Lord Goff of Chieveley.

nevertheless the wider context of the funding structure might suggest that there is no real expenditure:

> *"*A significant proportion of the consideration for their acquisition was provided from loans which were immediately returned to the lender in a way that had been pre-ordained. Whatever the purpose the loans were designed to serve, it is not obvious that it was to secure the acquisition of rights in software". *Tower MCashback*, Hope LJ p 793[88]

517. Aside from these indicators, *Tower MCashback* gives little other guidance on how to establish what is"real"expenditure. While the courts consistently use the yardstick of commerciality to judge the "reality" of these transactions, that term tends to be defined by what is not commercial rather than what is: Millett J in *Ensign* referring to commercial transactions which are not "*merely paper transactions*" while in *Ensign*

the Special Commissioners referred to the "the reasonable commercial terms such as might have been negotiated by parties with a normal concern to make profits" at p 765 [b] also saying that "the whole tenor of the documents leading up to the investment by Ensign..... is against any presumption of commerciality" at p746 [h]

518. In our view, in order for expenditure to be "real", as opposed to unreal or imaginary, it must have an actual effect, which must be evidenced by a change in the parties' position, both legally; has there been a change in ownership of the thing on which the expenditure is incurred and commercially; has there been a change in the risk which both parties take in the asset (in a standard sale agreement you would expect the asset risk to move from the seller to the purchaser).

519. Mr Thornhill stressed that the first year allowance being claimed in these transactions had as their wider fiscal purpose the encouragement of investment in start up entities. We agree; their purpose is to provide tax incentives to encourage investors to take risks by staking capital in new ventures. From that wider perspective too, it is relevant to ask what change in risk resulted from the acquisition of the software by these two partnerships.

520. We have already concluded that the existence of the warranty payments meant that the LLPs were effectively insured against any risk that the predicted income was not generated by the Software licences. Equally, the continued technical support and development of the Software licences was contracted back to their original developers who, in both cases, were also given buy back options. It is hard to identify any risks of ownership which had been transferred to either Appellant.

The value of the software licences

521. We have already concluded as part of our discussion about whether the LLPs were trading, that there was no rigorous attempt to establish what a reasonable market value for either the Daarasp or the Betex Software licences might be by anyone involved in the LLPs themselves. We took this to indicate that the activities carried on by the LLPs were not of the quality which would be expected of a serious trader genuinely interested in making a profit.

522. We have also rejected the suggestion that there was even the basis for a "genuine belief" in the fact that the two Software licences were worth the value which was ascribed to them by the LLPs.

523. On the contrary, our view of the evidence is that it suggests that the value of the Software licences was essentially fluid and its determination depended not on a truly commercial view of the underlying asset value, but on the amount of funds which were available to be invested into the LLPs. This is indicated by:

(1) The fact that the Betex investment was made in two tranches – In November 2005 and March 2006, suggesting that the funding obtained was driving the asset acquired rather than vice-versa.

(2) For Daarasp, the manner in which elements of the "worldwide licences" were carved out, at short notice and with no reference to the members, which seemed to be an attempt to match the value of the asset with the amount of funding obtained. Rather similar in this respect to the manner in which the software was divided "into bits" in *Tower MCashback.*

(3) The lack of a rigorous approach to valuation in either case; we have taken as significant for example, that the valuation of the Betex Software licence ignored specific risks (of regulatory change and significant existing competition) which were referred to in the valuation report provided by MECN.

(4) Charterhouse's emails with Valuation Consulting in November 2005 in respect of Betex in which the valuer seems to have been asked to reduce the value of the asset in line with the client's request.

524. Both parties accepted that it was not the Tribunal's role to determine what the correct value of the Software licences might be; we certainly do not have the expertise for that. However, we do think that the best way of establishing what the correct market value for the Software licences was at the relevant time is to establish what a third party was willing to accept for them.

525. We do not accept that either of the entities which we have referred to as "intermediate entities", Piebet and Damats, can be treated as third parties for these purposes. Nor do we accept that their role in the transactions suggests a real commercial involvement. Mr Thornhill pointed out that they had both been introduced for non-UK tax reasons, and we accept that, but nevertheless they are creatures of Charterhouse and the LLPs as HMRC point out:

(1) The only shareholder in Damats, a BVI company, was the Dama Purpose Trust, set up by Mr Hargreaves as trustee on 24 February 2004 through Jersey lawyers with the sole object of facilitating the acquisition of the Daarasp Software licence.

(2) The only shareholder in Piebet was the Squirrel Trust, this was set up by Mr Hargreaves on 29 September 2005 with Jersey lawyers as the original trustee and the sole object of facilitating the acquisition of the Betex Software licence.

(3) We did not see any evidence of any commercial involvement in the transaction by these two entities; no notes of any member meetings, no consideration of the value of the software, no indication that they were provided with any information about the transactions into which they were entering at all.

526. If Damats and Piebet are to be treated as bona-fide, third party, commercial acquirers of the software, we would expect to see evidence of real commercial negotiation of the price to be paid for the software, both in terms of the amount to be paid to the ultimate sellers (Parjun Enterprises and EMG) and the amount received from Daarasp and Betex. We saw no evidence of this at all.

527. We reject Mr Thornhill's contention that either Damats or Piebet should be treated as the real commercial sellers of the software when we are considering how the payments made by the LLPs for their Software licence should be treated.

528. The only "third party" sellers in these arrangements were those who already owned and developed the software, Mr Earle for Betex and Mr Makhdumi for Daarasp. Both of those third parties received payment for the software when they sold it on day one, but neither of them received a price close to the price which was paid by the LLPs to the intermediate sellers. EMG was entitled to receive £1.8 million of a total agreed assignment price of £65 million, (Initial Consideration of £1.641 million in November 2005 and Further Initial Consideration of £178,621 in March 2006), Parjun Enterprises received £1.4 million of a total agreed price of £18.188 million.

529. A day later, Damats received £18,188,244 for the Software licence from Daarasp, with no evidence that this raised any issues or concerns from Daarasp, or indeed from Parjun Enterprises, that it was paying significantly more than Damats appeared to be obliged to pay for the Software licence. Similarly, a day later Piebet received £65 million from Betex.

530. In our view it is telling in this regard that the Deed of Agreement between Parjun Enterprises and Damats refers to the Initial Consideration of £1.4 million but makes no reference at all to how the remainder of the consideration is to be paid, other than referring to the arrangements with Daarasp, the Hambros account and the obligation to make the Secondary Loans. There is no obligation in this agreement which obliges Damats to pay anything more than the initial consideration to Parjun Enterprises.

531. The Deed of Agreement between EMG and Piebet is slightly more explicit about the Balance of the Consideration, but also refers to the linkage between the payment of the remaining consideration and the arrangements between Piebet and Betex, the Hambros deposit and security arrangements and Secondary Loans. It is clear that the Balance of the Consideration is only payable to the extent that Piebet has "free funds" arising from these security, deposit arrangements and secondary loan arrangements.

532. We saw no evidence of any concerns being raised by those who sold the software and only received a small percentage of its purported value, or from the entities that acquired and then sold on the software, about this payment discrepancy. To our minds these are not commercial arrangements which anyone who was a third party would have entered into, or certainly not without raising significant concerns about why the payment flows were structured as they were. They could in fact be described as the "*mere paper transactions*" referred to by Millett J in *Ensign*.

533. This contrasts with the findings of fact in *Tower MCashback* where it was accepted that the purchase price was negotiated at arms' length between wholly unconnected parties and that the seller "adopted a tough negotiating stance".

534. We have no evidence that anyone, other than those involved in the arrangements, would have been prepared to pay, or would have expected to receive either £65 million

for the Betex Software licence or £18.118 million for the Daarasp Software licence in November 2005 or March 2004 respectively.

535. In our view the only amounts which can properly be treated as real expenditure on the Betex and Daarasp Software licences by Betex and Daarasp on those dates are amounts equivalent to the initial sums paid to the developers, being £1.4 million for the Daarasp Software licence paid in March 2004 and £1.641 million for the Betex Software paid in November 2005.

536. The Deed of Agreement between EMG and Piebet of November 2005 states that EMG is entitled to a "Further Initial Consideration" of £178,621 to be paid before 5 April 2006. We were not provided with any explanation of whether, when or why this additional sum was paid from Piebet to EMG before 6 April 2006 and we have not included this as part of the initial price paid for the Betex Software.

The funding structure

537. Even if we could conclude that the software licences were commercially valued, or valued on the basis of a genuine belief, at the higher amounts paid by the LLPs to Piebet and Damats, we agree with HMRC that the establishment of the blocked accounts at Hambros and the essentially circular nature of the payments into and out of those accounts leads to the conclusion that the sums in those accounts cannot be treated as "real expenditure" incurred on the Betex and Daarasp software.

538. In considering whether there has been real expenditure, the funding structure is relevant on our analysis because it is indicative of what level of commercial risk has been taken by the LLPs as purchasers of the software licences and the extent to which "real expenditure" has been incurred.

539. In our view the funding structure in both the Betex and Daarasp transactions did not entail either entity changing their commercial position, or taking on any real risk in the underlying assets; aside from the initial payments which were transferred from Damats and Piebet to the developers of the software, the remainder of the payments made by the LLPs were simply put on deposit with Hambros, earning a rate of interest equivalent to the rate which would have been earned had the LLPs merely put the money on deposit with a bank themselves and sufficient to ensure that there was income to allow the members to pay the (offsetting) interest obligations on their loans, also from Hambros.

540. The lack of risk incurred by members of the LLPs in respect of the loan capital invested in the LLPs is evidenced by the statement made by Charterhouse to investing members in their letter of 12 March 2004:"*Whilst is it not possible to make the loan non-recourse and totally risk free, to do so would prejudice the claim for loss relief, the reality is that the risk that you will be called upon to make actual personal repayments of the loan is very small"*.

Initial consideration

541. While we have accepted that an amount equal to the initial consideration payments made via Damats to Parjun Enterprises and via Piebet to EMG, can be treated as expenditure incurred on the Daarasp and Betex Software licences by Betex and Daarasp, we do have some concerns about how the actual payment flows between those entities worked.

542. Damats agreed to pay its Initial Consideration to Parjun Enterprises on 25 March 2004, a day before it entered into the Deed of Agreement with Daarasp under which it was due to receive £18 million. But it is not clear to us how it made the initial payment to Parjun Enterprises on the previous day; we saw no evidence that it had any source of funds other than the payments made, later, to it by Daarasp. The same issue arises for Piebet, at least in respect of its Initial Consideration payment on 4 November 2005, which must (as a matter of law) have been entered into before the Deed of Agreement transferring the software rights on to Betex. Both of those Deeds of Agreement refer to payment being made on the date when they were signed; in both cases that seems to be before any payment is received from the relevant LLP.

543. These payments by Damats and Piebet are not strictly relevant to our analysis of how the payments made by the two LLPs should be treated, but we have taken account of this as one indication of the fact that some of the agreements entered into may have been "*merely paper agreements*".

Remaining consideration

544. Tracing the funds paid by each LLP other than these initial consideration payments indicates that the financing was set up through the London and Channel Islands branches of Hambros so that all payments offset each other and no actual cash payments were required. We asked the Appellants to confirm whether interest payments and receipts had been offset but did not receive a clear answer to this.

545. The flow of funds in both structures is similar, with the main difference being that the loans to Betex are made partially through the nominee entity Redbar and partially directly to the LLP itself.

546. Starting with the loans made to the LLP members (or Redbar and Betex), these were made on the same day as the Deed of Agreement to purchase the software was entered into, by Hambros London. The loan takes the form of a facility under which notification needs to be given when an advance is required. We did not see any evidence of any such notices, (even for the second tranche of lending in the Betex structure). It is a condition of the loan that the sums advanced should be held in a specified account for the purpose of purchasing the relevant software at Hambros CI.

547. Presumably using those funds in the account at Hambros in the Channel Islands, payments are then made by the LLPs to their counterparty under the Deed of Agreement. That sum is immediately placed by the recipient (Damats or Piebet) back on deposit with Hambros CI, with interest payable, on the same day as the software rights are acquired.

548. Three further agreements are entered into on the same day: (i) A curious agreement under which Hambros CI agrees with Piebet and Damats to issue a guarantee to its London branch in respect of the obligations of the LLP borrowers (ii) A related security assignment over the deposit in favour of Hambros CI and (iii) A counter-indemnity provided by the counterparty (Piebet or Damats) for that guarantee.

549. The result of these arrangements as far as the capital of the loans is concerned, is that it has moved from the lender, Hambros London, to the original borrowers, through two Hambros entities, London and the Channel Islands, (but only one Hambros account, in the Channel Islands), and back, via the guarantee, security assignment and the counter-indemnity, to the original lender, Hambros London. We saw no evidence that this required any actual fund transfers. It is perfectly possible that the funds merely sat in the Hambros CI account.

550. A similar circularity exists as far as the interest payments are concerned; while interest is due on the deposits made by Piebet/Damats – this is off-set by the interest due on the loans to the LLP borrowers; that "interest" payment is transferred back to the LLP borrowers through the warranty obligations:

551. It is made clear in the Deeds of Agreement between Parjun Enterprises and Damats and EMG and Piebet that the warranty payments are intended to cover the interest payments which the LLP borrowers are obliged to pay:

> Clause 6: "*It will derive certain minimum levels of net operating income after expenses (but before depreciation and interest) sufficient to finance the interest on the loans which the [Daarasp] LLP partners will borrow from SG Hambros London*".

Clause 16 of the EMG – Piebet Deed of Agreement provides the same.

552. It was not clear to us that any actual "payment" was required to be made in respect of the interest payments either, with all amounts due and payable off-setting each other.

553. Unlike the facts in *BMBF*, there seemed to us to be no commercial impetus behind the choice of the offshore and London branches of Hambros for these transactions. Rather, the evidence which we saw suggested that Hambros had been used because it was invited to be involved by Peter Hargreaves at Charterhouse and it was Mr Hargreaves who had decided to use Hambros for these transactions; as Hambros' internal document considering the partnership scheme sets out:

> "*This scheme has been introduced to the Bank by Mr Peter Hargreaves, currently a director at Royal Bank of Canada. The scheme has been developed by Charterhouse Accountants, a professional services firm based in Harrow specialising in providing sophisticated tax advice*"
>
> and also stating that
>
> "*The risk to SGH is minimised as the funds will never leave SGH group control. Funds will be drawn down into the individuals' personal bank account with SGH London and then transferred, together with the member's personal contributions,*

through Daarasp LLP's bank account with SGH London into the Damats Account with SGH Jersey to purchase the software licence".

554. Mr Thornhill suggested that these two arrangements were not like the arrangements in *Tower MCashback* because the monies paid did get to the sellers of the Software licences. That conclusion rests on viewing Damats and Piebet as the sellers of the Software licences. We know that those entities were inserted into the structure for New Zealand tax (Piebet) and banking regulation (Damats) purposes, but the fact that they were not inserted for UK tax purposes does not automatically give them commercial substance.

555. In our view the insertion of these two entities does not break the funding loop, as Mr Thornhill suggests; Damats and Piebet can best be seen as conduit entities which, while in legal terms might have been the sellers of the Software licences, in commercial substance were no more than intermediate entities inserted for legal and not commercial purposes.

556. If we ignore those two entities from a commercial perspective, other than the initial consideration, the payments made by the two LLPs went no nearer to the ultimate sellers of the software than the payments did in the *Tower MCashback* case.

557. Any suggestion that, by the holdings in the two trusts (the Squirrel Trust and the Damats Trust) those ultimate sellers did have access to the funds paid by the two LLPs seems to us to be at too remote a remove as to be taken to be a serious commercial proposition and also not in line with the terms of the trust agreements which we saw;

(a) The Squirrel Trust did not stipulate any beneficiaries and had a firm of Jersey lawyers as its trustees.

(b) The Dama Trust did stipulate that Mr Makhdumi and his family were the ultimate beneficiaries of the trust but the Trust would have access to the LLP's payments for the Software licences only after all other obligations had been settled, including the repayment of the Secondary Loans, which, by definition, would be equal to the sums owing for the software licences.

558. In conclusion, the funding structures employed by both Daarasp and Betex ensured, as Hambros themselves said, that the monies lent never left Hambros' control. The warranty payments ensured that neither Daarasp nor Betex were exposed to any commercial risk of payments being made or not made in respect of the software rights which they had acquired. Referring back to our reality test; what actual effect, evidenced by a change in the parties' commercial or risk position did these transactions have? In our view, almost none.

The option agreements

559. Neither party relied to any great extent on the significance of the option agreements, but Mr Thornhill did suggest that they supported the general commerciality of the deals and the profit expectations for the software.

560. We did not see any evidence of how the option strike prices for any of the options were agreed or whether they were negotiated by any of the parties involved. Nor did we see how the existence of those options was taken account of in the valuation of the Software licences or how it was accounted for by the relevant parties.

561. These aspects of the option agreements have also coloured our conclusions about the overall reality of the financial arrangements surrounding these transactions.

Documentary discrepancies

562. We have not taken any particular points on some apparent inaccuracies and gaps in the financing documents, but it does seem to us to add if only incrementally, to the general picture of agreements which have not been negotiated or reviewed in the way that financing documents which represented a real financial risk to the borrowers would have been negotiated and reviewed.

Conclusion

563. Overall we have concluded that the description of the financing given by Walker LJ in *Tower MCashback* applies just as well here:

> "*In this case there was a loan, but there was not, in any meaningful sense, an incurring of expenditure of the borrowed money in the acquisition of software rights. It went in a loop in order to enable the LLPs to indulge in a tax avoidance scheme"* at [75] p 789

564. For these reasons we have concluded that if any real expenditure was made for the real purpose of Betex or Daarasp acquiring software assets for the relevant periods, that expenditure was limited to amounts equal to the initial payments which were made to EMG and Parjun Enterprises. Any qualifying expenditure for which capital allowances are available should therefore be limited to those amounts, being for Betex the £1.641 million paid to EMG on 4 November 2005 and for Daarasp the £1.4 million paid to Parjun Enterprises on 25 March 2004, subject to our conclusions on the further technical issues set out below.

Question 4 - Was the expenditure incurred by a "small enterprise" as required by s 45(1)(b) CAA 2001?.

565. If Daarasp or Betex cannot be treated as a "small enterprise" for the purposes of s44(1)(a) they will not be entitled to claim the first year allowances which have been claimed for their expenditure on the Daarasp and Betex Software licences.

566. In order to be a "small enterprise" the LLPs must also be a business as defined by s 48 CAA 2001:

"***48 expenditure of small or medium-sized enterprises; businesses***

(1) Use this section to decide whether expenditure incurred by a business is, for the purposes of this Chapter, incurred by –

(a).....
(b) a small enterprise

567. S 48(2) defines what is meant by a "business" for these purposes, being either a partnership of which all members are individuals, which it is accepted does not apply to Daarasp, which has Piedama Limited as a partner, or "*a body corporate which is not a company but is within the charge to corporation tax*" s48(2)(d)

Appellants' arguments

S48(2)(d)

568. Mr Thornhill argued that both Daarasp and Betex fell within s 48(2)(d) as body corporates within the charge to corporation tax. They are both LLPs and so body corporates in accordance with s 1(2) of the Limited Liability Partnership Act 2000 although not a company for the purposes of general law:

"1(2) *A limited liability partnership is a body corporate (with legal personality separate from that of its members) which is formed by being incorporated under this Act; and*

a. in the following provisions of this Act..... and
b. in any other enactment (except where provision is made to the contrary or the context otherwise requires)

references to a limited liability partnership are to such a body corporate"

569. For tax purposes an LLP is treated as a company, because all body corporates are treated as companies for tax purposes by reasons of s 6 and s 832 ICTA 1988:

"*company" means..... any body corporate or unincorporated association but does not include a partnership, a local authority or a local authority association"*

570. S 118ZA ICTA 1988 imposes a fiction that, despite an LLP being treated as a company for tax purposes, its business is treated as carried on by its members, i.e. it is treated for these purposes as transparent.

571. Following that logic, Daarasp and Betex can both be treated as a small enterprises and there seems to be no policy reason why such an entity should be excluded from the ability to claim first year allowances under s 44 CAA 2001.

S 48(2)(b)

572. Alternatively, Betex has no corporate members and so qualifies as a small enterprise under s 48(2)(b) CAA 2001. Daarasp has one corporate member, Piedama but Mr Thornhill suggested that on a purposive construction of s 48(2)(b) Daarasp should also fall within its terms since the only reason for its having a corporate member was to ensure that it had two members and Piedama Limited had no interest in profits or assets of Daarasp. Mr Thornhill relied on First-tier Tribunal decision *Hoardwheel Farm Partnership,* which considered the treatment of a mixed partnership including a dormant company for this conclusion.

573. Mr Thornhill also pointed out that this issue was raised in *Tower MCashback* but was not pursued Henderson J in the court of appeal p 703 [24]: "*It is common ground that LLP1 and LLP2 were small enterprises within the meaning of s 44 and 45"*

HMRC's arguments

574. Ms Nathan's view is that Daarasp cannot be treated as a "small enterprise" under s 45(1)(b) CAA 2001. It does not fall within s 48(2)(b) because it has a corporate partner and cannot fall within s 48(2)(d) because it is a transparent entity for tax purposes.

S 48(2)(d)

575. Her route to this conclusion starts with s 48 CAA 2001 because, as a result of s 118ZA ICTA 1988 both Appellants are treated "for the purposes of the Tax Acts" as partnerships, including for the purposes of the CAA 2001. Daarasp is subject to income tax, not corporation tax, if it is an LLP carrying on a business with a view to profit:

"*118ZA Treatment of Limited Liability Partnerships*

(1) For the purposes of the Tax Acts, where a limited liability partnership carries on a trade, profession or other business with a view to profit –

(a) all the activities of the partnership are treated as carried on in partnership by its members (and not by the partnership as such).....

(2) For all purposes, except as otherwise provided by the Tax Acts –

(a) References to a partnership include a limited liability partnership in relation to which subsection (1) applies

(b) .....

(c) References to a company do not include such a limited liability partnership, and

(d) References to members of a company do not include members of such a limited liability partnership"

576. Ms Nathan points out that it is anomalous for the Appellants to argue, as they must in order to obtain capital allowances which are available to their members, that the LLPs are transparent and nevertheless suggest that they are subject to corporation tax.

577. "Business", as defined by s 48(2) CAA 2001 excludes a partnership which has a trust or a company as a member. Therefore Daarasp cannot be treated as a small enterprise and cannot claim first year allowances for its expenditure on the Daarasp Software licence.

Decision on Question 4

578. We agree with HMRC's interpretation of these provisions. While it is correct that in principle an LLP is treated as a body corporate for tax purposes as a result of being a body corporate under the Limited Partnership Act, it is a true hybrid and is not subject to tax as a body corporate, it is subject to tax, in accordance with s 118ZA ICTA 1988 at the level of the members, i.e. as a transparent entity. While that might be a fiction for legal purposes, it is not a fiction for tax purposes.

579. In our view it is the tax, not the legal character of Daarasp which is relevant for the purpose of s 48(2)(d); an entity will only be within that section if it is within the charge to corporation tax. While the general rules at s 6 and s 832 ICTA 1988 might suggest that Daarasp is within the charge to corporation tax, the more specific rules at s 118ZA which apply for the purposes of the Tax Acts, over ride this and remove any corporation tax charge at the level of the LLP. The specific provisions at s 118ZA(2) ICTA 1988 treat limited liability partnerships as partnerships for the purpose of the Tax Acts, taking them outside the scope of corporation tax.

580. We also agree with HMRC that it would be anomalous for the taxpayers to argue that Daarasp should be treated as liable to corporation tax, meaning that any capital allowances were available only at the level of the LLP, while also claiming that its members should be able to claim their share of those losses.

Conclusion

581. We have concluded that Daarasp cannot be treated as a "small or medium sized enterprise" and cannot therefore claim first year capital allowances under s 45 CAA 2001.

Question 5 - Is the expenditure on the software licence precluded from capital allowances under s 44 CAA 2001? Daarasp only.

582. The parties agreed that, if relevant at all, this issue is relevant only to the Daarasp structure and arises because of the exclusions in general exclusion 5 of s 46 CAA 2001 which states that first year allowances under s 45 CAA 2001 are not available for

expenditure which "*would be long life asset expenditure but for paragraph 20 of Schedule 3 (transitional provisions)".*

583. The Daarasp Software licence was granted for a term of 25 years. The parties accept that the Daarasp Software licence falls within the general definition of "*long life assets*" at Part 2, Chapter 10 CAA 2001 and specifically s 91(1).

Appellant's arguments

584. On behalf of Daarasp Mr Thornhill argued that general exclusion 5 at s 46 applied only to a very specific type of expenditure on long life assets, being certain "old" long life expenditure which is excluded from the scope of first year allowances.

585. Mr Thornhill pointed out that general exclusion 5 is drafted in very different terms to the exclusion for long life assets at s 44 CAA 2001 which simply states at 44(2) "*Long life asset expenditure is not first year qualifying expenditure under subsection (1)*". If the intention had been to exclude all long life assets under general exclusion 5, it would have been drafted in similar terms, but it is not.

586. Since the Daarasp Software licence is not a long life asset expenditure which would fall within paragraph 20 of Schedule 3, general exclusion 5 does not apply and the Daarasp Software licence expenditure does qualify for first year allowances.

HMRC's arguments

587. In contrast, Ms Nathan's approach to the interpretation of general exclusion 5 is that it is an inclusive and not an exclusive test; the expenditure on the Daarasp Software licence is long-life asset expenditure and is not expenditure which falls within paragraph 20 of Schedule 3, therefore the expenditure is excluded from first year allowances by s 46.

Decision on Question 5

588. We have to admit that the drafting of general exclusion 5 of s 46 CAA 2001 is odd; applying an exclusion by starting with a condition that;"the expenditure would be long-life asset expenditure" is unusual, but to our minds does suggest that this condition is an a-priori element of the exclusion, so that the first question to ask is; does this expenditure fall within paragraph 20 of Schedule 3?

589. Paragraph 20 of Schedule 3 is headed "Long-Life Assets, Long-life asset expenditure" and is itself an exclusion provision, taking certain expenditure outside the scope of the long life asset rules, stating:

> *"20(1) Chapter 10 of Part 2 [the long-life asset chapter of the CAA 2001] does not apply to any expenditure incurred –*
>
> *(a) before 26th November 1996, or*

(b) *before 1st January 2001 in pursuance of a contract entered into before 26th November 1996*".

590. On this basis, the only type of expenditure which "*would be long-life asset expenditure but for Paragraph 20 of Schedule 3*" is the expenditure which is excluded by those provisions, i.e. pre-26 November 1996 expenditure, which the expenditure on the Daarasp Software licence is not.

591. Mr Thornhill accepted that this seems a rather strange provision and could not provide an explanation for why the exclusion should have been drafted in this way.

592. We have considered whether it is possible to construe the drafting, as Ms Nathan suggested, to exclude not simply pre-26th November 1996 long-life asset expenditure, but all long-life asset expenditure, including pre-26th November 1996 long life asset expenditure.

593. The first problem with this approach is to wonder why, if all long-life asset expenditure was intended to be excluded, the draftsman did not say so in exactly the same clear terms as were used in s 44? If it was thought that pre-26th November 1996 long-life asset expenditure needed to be specifically considered, why could the provision not have referred to long-life asset expenditure including long-life asset expenditure which would have been long life asset expenditure but for Paragraph 20 of Schedule 3?

594. If it was the intention of the draftsperson to include all long-life asset expenditure, it is not clear that this is what has been achieved by general exclusion 5.

Conclusion

595. On balance and not without some misgivings because of the rather curious result which this achieves, we agree with Mr Thornhill that the better construction of general exclusion 5 is that it only operates to exclude long-life asset expenditure which is otherwise excluded by paragraph 20 of Schedule 3. It therefore does not apply to the expenditure on the Daarasp Software licence and does not operate to deny the Appellant's claim for first year capital allowances.

Question 6 – The anti-avoidance rule at s 215 CAA 2001: Was the sole or main benefit which accrued to the Appellants the obtaining of capital allowances?

596. We are considering this provision briefly because it was raised by the parties. Given our previous conclusions it is unlikely to be relevant.

Appellants' arguments

597. Mr Thornhill's starting point on s 215 is that there is not a "relevant transaction" as defined by s 213, since neither Daarasp nor Betex acquired their Software licences by way of a sale, but by way of the grant of a licence.

598. However, Mr Thornhill says that if the transfer of the rights in the Software licences can be treated as a sale for these purposes, the test applied by s 215 is objective. If a commercial benefit has been obtained as a result of the transaction, then s 215 cannot be in point. In any event, the test should be applied by weighing up the benefit of the expenditure (the obtaining of the Software licences) with the benefit of the first year allowances, as was done in the *Garrett Paul Curran* decision,

> "In order to ascertain the benefits flowing from the relevant transaction, it is necessary to consider the position of the taxpayer before and after the transactions" [223] and
>
> "Whilst it is not necessary for ever benefit to be capable of valuation in money terms in order that it be taken into account, where benefits are susceptible to such valuation, the resultant values fall to be taken into account and compared" [225]

with the result in this case that the main benefit of the transaction cannot have been the obtaining of allowances**.** Had the Software licences produced the profits which were anticipated, those profits would have greatly exceeded the value of the allowances

.

HMRC's arguments

599. HMRC's starting point is that the entities who benefited from the relevant transactions are the members of the two LLPs, the benefit which they obtained was the benefit of the losses generated as a result of the Appellants' claims for capital allowances.

600. Ms Nathan suggested that the acquisition of the software by Daarasp and Betex could be treated as a relevant transaction under s 213(1)(a) CAA 2001.

601. Ms Nathan argued that the reference in s 215 to the sole or main benefit accruing to "any other party" extends the scope of the provision to the LLP members, whose benefit was the losses which they could claim as a result of the LLPs claiming capital allowances.

602. HMRC say that there is evidence that the aim of the transactions was to secure those first year capital allowances, including;

(1) the fact that a disclosure had been made by the Appellant to HMRC under the Disclosure of Tax Avoidance Scheme (DOTAS) rules,

(2) the focus on the availability of allowances in the PMID,

(3) the suggestion that the software was identified in order to fit into the scheme rather than vice-versa,

(4) the fact that the LLP members were exposed to very little downside risk (as a result of the warranty payments),

(5) the limited amount of due diligence and care taken in acquiring and exploiting the software by the LLPs and the members' apparent lack of interest in the profitability of the transactions.

603. If any claims for capital allowances are available, they should be restricted to the market value of the software, in accordance with s 218 CAA 2001, which on the basis of Mr Sykes evidence was only between £25 thousand and £120 thousand for Daarasp and between £250 thousand and £1 million for Betex.

Decision on Question 6

604. In our view, at the very best, the only possible element of the Appellants' appeal which may have sailed through the rocky waters of each of arguments one to five to reach this final stage of our analysis is a claim by Betex for first year capital allowances equivalent only to the £1.641 million which was paid by Betex to Piebet and by Piebet to EMG on 4 November 2005.

605. We are treating the "relevant transaction or transactions" for the purpose of s 215 in this context as Betex's payment of the full amount of the £65 million sale price of the Betex Software licence to Piebet on 4 November 2005, being the transaction under which Betex became the owner of the Betex Software licence.

Relevant transaction

606. To deal first with the question of whether this amounts to a "relevant transaction"; under the Deed of Agreement dated 4 November 2005 Betex acquired a licence over the Betex Software from Piebet, being a licence to exploit the Betex Software.

607. In response to Mr Thornhill's point that this grant of a licence over the Betex Software is not a relevant transaction as that is defined by s 213 CAA 2001, our view is that the section is drafted in terms of either the sale of an asset or a transfer under a contract through which the acquirer becomes the owner of the asset, reflecting the general approach of the capital allowances legislation that allowances can only be claimed on assets which are owned.

608. Mr Thornhill has not suggested for any other purpose that Betex did not own the Software licence. Our view is that the grant of the licence to Betex, although not drafted in terms of a classic sale contract, did result in Betex owning the asset (the licence in the Betex Software) in respect of which allowances were claimed and therefore can be treated as a "relevant transaction" falling within s 213(b) CAA 2001.

The main benefit of the expenditure

609. The parties agreed that the test in s 215 was an objective test, similar to the test at s 787 ICTA 1988, but not how and to which entity that test should be applied**.**

The main benefit to Betex

610. In our view, looking at this first from the perspective of Betex itself, and having concluded that a significant proportion of its £65 million payment to Piebet was not incurred on the software at all, but held in a blocked account at Hambros, it is not possible to conclude that the main benefit of all of this payment was the acquisition of the Betex Software licence.

611. It may be possible to suggest that the main benefit of the part of the expenditure which was paid from Piebet to EMG (the £1.641 million) was to acquire the Betex Software licence, but we do not think that this is sufficient since s 215 must be answered in respect of the whole of the payment made under the relevant transaction.

612. If the main benefit of the expenditure was not to acquire the Betex Software licence, and assuming that such a large payment would not be made without intending to obtain some benefit, it is difficult to avoid the conclusion that main benefit must have been to obtain the first year allowances which were available to Betex.

613. We have considered whether we can conclude this despite the fact that, looking at Betex alone (without taking account of its underlying members) those first year allowances were of no value to it, since it had no profits (nor, on our analysis any prospect of making profits) against which those allowances could be off-set.

614. Our conclusion is that considering Betex alone it is not possible to ascribe to it a main benefit of obtaining first year allowances which would be, from its own perspective, worthless. Mr Thornhill suggested that a weighing up exercise was appropriate by reference to the *Garrett Paul Curran* decision, but he assumed that the capital allowances were valuable by reference to their full tax value to Betex. Even if we accept this rather mechanistic approach to determining the benefit obtained, we saw no evidence of how those allowances would have been valued by Betex.

615. For this reason we do not accept that the obtaining of capital allowances can be treated as the main benefit of Betex's entering into this transaction.

The main benefits of other parties

616. Ms Nathan pointed out that s 215 extends the scope of its provisions not just to the parties to the relevant transaction (Betex and Piebet) but also to "any other party", which in her view is wide enough to encompass the members of the Betex partnership, for whom the use of the first year allowances as tax losses which may be available against their own taxable income, would be valuable.

617. Our problem with this argument is twofold:

(1) We are not convinced that the reference to "other party" in s 215(b) can readily be extended to include the members of Betex. While they are "other persons" they are not a party to the relevant transaction or to any of the other transactions related to the obtaining of allowances by Betex, since Betex has a separate legal personality.

(2) In coming to this conclusion we have taken account of the provisions at s118ZA ICTA 1988 that

> "For the purposes of the Tax Acts, where a limited liability partnership carries on a trade, profession or other business with a view to profit –
>
> (a) all the activities of the partnership are treated as carried on in partnership by its members (and not by the partnership as such)"

but we are not certain that imputing the activities of the partnership to its members necessarily also involves imputing the legal contracts entered into by the LLP to its members.

(3) Second, other than the evidence which we heard from Mr Lee, we were not provided with any evidence about the position of any of the members of the LLP, how they viewed their investment or what their motives or benefits in becoming members of the Betex LLP might have been.

618. For these reasons, we do not accept that s 215(b) CAA 2001 is wide enough to encompass the benefits obtained by the members of Betex.

Did Betex's benefits include the benefits of its members?

619. Finally, we have considered whether, in determining the benefit accruing to Betex itself, it is possible to take account of any possible benefits accruing to its members, asking ourselves whether Betex viewed the main benefit of its transaction with Piebet that it was able to claim first year allowances and its members would be able to claim losses to set against their own tax payments.

620. We have considered this question bearing in mind that:

(1) The Appellant treated the Betex transaction as a reportable transaction for DOTAS purposes.

(2) The PMID suggested that the availability of first year allowances was an important part of the investment (for the investing partners).

(3) Correspondence which we saw between Hambros and Charterhouse strongly suggests that these transactions were one in a series of so called "software arrangements" which were recognised by Hambros as tax planning arrangements, as stated for example in their email of 10 November 2005 (from Adrian Rowland to Eric Barnett), saying:

> "*Please find..... a copy of a credit proposal.....for another round of "Software" planning"..... I have been through it and am satisfied with the risks and that it is in line with the other 2 Software deals which we have done over the last 12 months"*

621. Again, we think this is a difficult analysis on the basis of the evidence which we have seen and heard, which did not extend in any detail to the benefits accruing to the members of the LLP.

622. The analysis would, we think, be different were we dealing with a true partnership, in which there would be a complete coincidence between the legal identity of the partners and the partnership, and therefore presumably also of objects and benefits, but that is not the case with a limited partnership such as Betex which has a separate legal identity.

Conclusion

623. In our view while it might be possible to conclude that the Betex arrangements are part of a transaction which was intended to provide losses to members by reason of generating first year allowances, we do not think that this is enough to bring s 215 into play for Betex itself.

624. For these reasons we have concluded that the anti-avoidance rule at s 215 CAA 2001 cannot be applied to deny or restrict Betex's claim for capital allowances.

Final conclusions

625. We have concluded that Daarasp's appeal against HMRC's Closure Notice issued on 26 January 2011 reducing Daarasp's loss figure for the 2003-4 tax year to nil should not be allowed.

626. We have concluded that Betex's appeal against HMRC's Closure Notice issued on 7 February for the 2005-6 tax year reducing Betex's loss figure to nil should not be allowed.

627. We have concluded that the terms of the Closure Notices issued to both Appellants do not restrict the matters under appeal and in particular that we can properly consider the issues which we have referred to as questions 2, 4, 5 and 6 as part of this appeal.

628. We have concluded that neither Daarasp nor Betex can be treated as trading at the time when the qualifying expenditure was incurred for first year allowance purposes, or, for the avoidance of doubt, in subsequent accounting periods.

629. We have concluded that, even could Daarasp or Betex be treated as trading at the relevant time, the amount of expenditure which can be treated as incurred on a

qualifying asset for first year allowance purposes is for Daarasp £1.4 million and for Betex £1.641 million.

630. We have concluded that Daarasp cannot be treated as a "small enterprise" and so cannot claim first year allowances under s 45(1)(b) Capital Allowances Act 2001.

631. We have concluded that the long life asset rules at s 44 Capital Allowances Act 2001 do not apply to exclude expenditure on the Daarasp Software licence from first year allowances.

632. Finally, we have concluded that the anti-avoidance rule at s 215 Capital Allowances Act 2001 does not apply to an LLP such as Betex which is generating capital allowances in order for its members to claim losses to offset against their own tax liabilities.

633. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

Rachel Short

TRIBUNAL JUDGE
RELEASE DATE: 13 September 2018