[2013] UKUT 0368 (TCC)
Appeal number FTC/40/2012

CORPORATION TAX - Claim for capital allowances in respect of ships where the end sub-lease was to a non-UK resident user - Time charter to that end user granted by a UK resident company that claimed that its role (as the disponent owner under the time charter) satisfied the terms of section 123 Capital Allowances Act 2001, and therefore constituted a "qualifying user" so preserving the Respondent finance leasing company's entitlement to 25% writing-down allowances - Three issues the subject of the appeal by HMRC, and one the subject of a cross-appeal by the Respondent

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Appellants

- and -

LLOYDS TSB EQUIPMENT LEASING (NO 1) LTD

Respondent

TRIBUNAL: MR JUSTICE NEWEY
JUDGE HOWARD M. NOWLAN

Sitting in public at the Rolls Building in London on 22 – 26 April 2013

David Ewart QC, Raymond Hill and Stephanie Barrett, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellants

Jonathan Peacock QC and Michael Ripley, instructed by Norton Rose LLP, for the Respondent

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DECISION

Introduction

5 1. This is an appeal by HM Revenue and Customs ("HMRC") against the decision of the First-tier Tribunal (Tribunal Judges Edward Sadler and Adrian Shipwright) in favour of the Respondent, Lloyds TSB Equipment Leading (No 1) Ltd ("Lloyds Leasing"), on three of the four points in dispute in this case. Lloyds Leasing also appeals, against the decision of the Tribunal
10 ("the FTT") in favour of HMRC on the fourth disputed point.

2. The basic issue in this case is whether Lloyds Leasing was entitled to 25% writing-down capital allowances (indeed any capital allowances) in respect of its purchase of two ships designed to transport liquefied natural gas ("LNG"),
15 having regard to the fact that the ships were ultimately leased to non-UK resident lessees. Notwithstanding that HMRC succeeded on one point, the FTT's decision ("the Decision") meant that Lloyds Leasing sustained its full claim for 25% writing-down allowances. The total expenditure incurred on the two ships was £198,226,884. The largest claim for allowances was made
20 for Lloyds Leasing's accounting period ended 30 September 2006, when the two ships were delivered, and this is the period to which the appeal relates. The outcome of the appeal would naturally have a bearing on claims in later periods during which further claims would be made for writing-down allowances as well as affecting the potential recovery of allowances given in
25 earlier years.

3. All four points in dispute revolved around the interpretation and then the application of the provisions of section 123 of the Capital Allowances Act 2001 ("the CAA"). In other words, Lloyds Leasing's entitlement to writing-
30 down allowances in this case depends on whether the role undertaken by a company that we will refer to below as "K-Euro" satisfies all the requirements of section 123, and thus precludes other sections of the CAA, that limit allowances in respect of "overseas leasing", from eliminating the entitlement to allowances because the end-users of the vessels are non-UK
35 resident companies. In view of this, it may be of assistance if we say something at this stage about the purpose of section 123 and the context in which it appears. Once we have outlined the statutory provisions, and then the facts, we will identify the four matters in contention.

40 ### *Section 123 and its context*

4. In terms of context, it is first important to remember that, at the time the expenditure in question in this appeal was incurred, capital allowances could generally be claimed by a finance lessor, as the legal owner of plant and
45 machinery, regardless of the fact that the finance lease would usually have passed the equity and residual interest in the plant and machinery to the lessee.

5. Section 123 of the CAA is contained in the Chapter of the Act that deals with "overseas leasing". It was common ground between the parties that the overall policy underlying the overseas leasing provisions was to prevent any undue benefit of UK writing-down allowances from flowing to non-UK residents.

6. The essential benefit of 25% writing-down allowances is that they generally provide tax relief for capital expenditure on a more accelerated, and thus more beneficial, basis than that on which depreciation is usually claimed for accounting purposes. Similarly, where plant and machinery were acquired by finance lessors (and the allowances were still available – as in the present case – to the finance lessors rather than the lessees who had the equity and reversionary interest in the plant and machinery), 25% writing-down allowances were often available in advance of the profile for the recovery of that expenditure by the finance lessors in the form of rentals. Some of the benefit of the tax relief could be passed on to lessees by reducing their rentals below the amounts that finance lessors would have charged had they simply lent the lessees the funds to acquire the plant and machinery themselves and charged interest on the loans.

7. The overseas leasing provisions sought to limit the extent to which non-resident lessees benefit from UK allowances in two ways. One provision, section 109 of the CAA, reduced the rate of writing-down allowance from 25% to 10% on the premise that, at this rate, the timing benefit of accelerating the lessor's allowances would be very modest. Where attempts were made to increase that timing benefit by various expedients (for instance, by having a finance lease for more than 13 years, by having "renewal periods", or by having "stepped rentals" that would commence at a low rate and then progressively rise in later years), section 110 of the CAA provided that no capital allowances would be available at all. This provision not only eliminated the benefit of accelerating tax relief ahead of the time the expenditure was recovered in the form of rental receipts, but provided of course a massive disincentive for finance leasing in that the lessor would be taxed on all rentals, recovering in taxable form capital expenditure for which no relief of any form would have been available.

8. Section 123 of the CAA effectively ousted the application of sections 109 and 110 in relation to expenditure on ships and aircraft let to non-UK residents in certain limited circumstances. As regards expenditure on ships, section 123 was said to have been designed to protect the UK shipping industry. It achieved this by providing that if a UK resident leased a ship to a non-UK resident, the use of the ship would be "for a qualifying purpose" and thus, within another definition, constitute "protected leasing" and thereby escape the provisions of both sections 109 and 110 if various conditions were met. Accordingly, 25% writing-down allowances would still be available. Before quoting the whole section, we summarise that it was to apply where a

UK lessor (a) was carrying on a trade which included operating ships, (b) was responsible for navigating and managing the ship in question throughout the period of the charter, and (c) was responsible (either directly or through an agent) for defraying either (i) all the expenses in connection with the ship throughout the period of the charter, or (ii) substantially all such expenses other than those that were voyage specific. In other words, the section was designed to operate where a UK trader provides a ship pursuant to a time charter, under which it actually operates the ship and defrays the cost of manning and maintaining it, as distinct from the case where a ship is the subject of a bareboat charter.

9. Ignoring the references to aircraft, the relevant provisions of section 123 of the CAA were as follows:

> "(1) A ship is used for a qualifying purpose at any time when it is let on charter in the course of a trade which consists of or includes operating ships by a person who is:
>
> (a) resident in the United Kingdom or carries on the trade there, and
> (b) responsible for navigating and managing the ship throughout the period of the charter and for defraying–
>
> (i) all expenses in connection with the ship throughout that period, or
> (ii) substantially all such expenses other than those directly incidental to a particular voyage or to the employment of the ship during that period.
>
> (2) …
>
> (3) For the purposes of subsection (1)(b) a person is responsible for something if he -
>
> (a) is responsible as principal, or
> (b) appoints another person to be responsible in his place.
>
> (4) Subsections (1) and (2) do not apply if the main object, or one of the main objects–
>
> (a) of the letting of the ship … on charter,
> (b) of a series of transactions of which the letting of the ship … on charter was one, or
> (c) of any of the transactions in such a series,
>
> was to obtain a writing-down allowance determined without regard to section 109 (writing-down allowances at 10%) in respect of

expenditure incurred by any person on the provision of the ship or aircraft."

The material facts

10. The Decision provides a full description of the facts, the material documentation and the evidence. It is accordingly sufficient for the purposes of this decision to state the facts in relatively summary form. As will become clear, the relevant transaction evolved over a period spanning from early 2001 until the delivery of the ships in 2006, and the facts need to be understood at each stage.

Events in 2001

11. The initial stage involved an invitation by various non-UK resident oil companies, headed by the Norwegian energy company Statoil ASA ("Statoil"), for shipping companies to tender for contracts to acquire two LNG carriers and to operate those ships on a time charter basis for the oil companies. The relevant oil companies, which were referred to collectively as "the Snøhvit Sellers", were developing natural gas fields under the Norwegian sector of the Barents Sea.

12. The tender process commenced in January 2001. The need for reliable long-term supply facilities, coupled with a previous lack of experience in shipping LNG in the Atlantic region, led the Snøhvit Sellers to emphasise during the tender process that they had a preference for the LNG carriers to be supplied by companies that were financially reliable long-standing shipping companies, ideally with both experience of shipping LNG in other parts of the world and a facility to manage the ships from the Atlantic time zone.

13. The tender process was won by the long-established Japanese shipping line, Kawaski Kisen Kaisha Limited ("K-Line"). K-Line was seeking to expand its business in Europe and the Atlantic Basin, and to manage that business regionally, and one of its attractions in the competition for the contracts to acquire and charter the ships to the Snøhvit Sellers was the fact that it could use a UK subsidiary referred to as K-Euro to deal with the management of the ships, as required, in the Atlantic time zone. At the time, K-Euro's business comprised the operation of coastal container ships in European waters and a general agency for K-Line's container and car carrier business in Europe. It was envisaged, however, that with a general expansion of its business, K-Euro was well placed to deal with management in the Atlantic time zone.

14. Having won the tender process, K-Line itself entered into contracts with Japanese shipbuilders for the construction of the vessels, and also time charterparties of those vessels to Statoil on behalf of the Snøhvit Sellers for a minimum period of 20 years, with the possibility of two 5-year extensions.

All these contracts were entered into on 19 December 2001. The rate of hire under the time charterparties was set as part of the tender negotiation and was split into two elements: capital expenditure and operating expenditure. The operating expenditure element itself included certain components that were fixed in advance and others that depended on the costs ultimately incurred by the owner.

15. Statoil and K-Line entered into a memorandum of understanding ("the MoU") on the same date. During the tender process, K-Line had sought advice on various structures for financing the vessels, and lease finance had been researched in a number of jurisdictions. It seems that UK leasing had emerged as potentially attractive, and the MoU reflected this by confirming that the parties intended to implement UK tax leasing arrangements in financing the vessels, though the MoU also stated that "[i]f UK lease arrangements [were] not found to be economically and/or legally viable" the parties would "arrange new financial scheme(s)".

The September 2002 transactions

16. On 19 September 2002, the leasing structure was put in place.

17. Lloyds Leasing had been selected as the intended owner of the two vessels, so the shipbuilding contracts were novated; progress payments already made by K-Line were refunded and then replacement payments made by Lloyds Leasing, with the latter becoming the purchaser of both vessels and taking on the liability to pay the balance of the contract prices.

18. Lloyds Leasing then granted a fairly conventional finance lease, with a 30-year primary period, to each of two specially formed, and resident, Cayman Islands companies, the lease in respect of one of the vessels being granted to one, and the lease of the other to the second company. The share capital of both companies was owned by K-Line and Statoil, and by two substantial Japanese companies, Mitsui & Co. Limited ("Mitsui") and Iino Kaiun Kaisha Ltd ("Iino"). For some reason, the percentages of shares owned by each of the shareholders differed as between the companies. K-Line owned 49% of the shares in one of the companies (referred to as "Northern LNG I"), but only 36% in the other (referred to as "Northern LNG II"). For its part, Statoil owned 50% of the shares in Northern LNG II, but just 14% in Northern LNG I.

19. The material point in relation to the leases of the vessels from Lloyds Leasing to the Northern LNG companies is that, under the familiar terms of finance leases, the risk of having to bear additional costs under the finance leases, and correspondingly the hope and expectation of receiving the value of the ships at the end of the primary period (and effectively therefore the beneficial ownership of the ships), was vested in the two Northern LNG companies.

20. In their turn, and as the next of the 19 September 2002 transactions, the two Northern LNG companies granted bareboat charters to K-Euro, the UK resident company already mentioned. The bareboat charters were for 20 years, with K-Euro having two options, each to extend the bareboat charters for a further five years. We were told that the rent under the bareboat charters was set at a rate believed to be a reasonable commercial rate.

21. The final transactions on 19 September 2002 involved the novation to K-Euro of K-Line's role under the time charters to the Snøhvit Sellers. As we have already indicated, the terms of the time charters of the two vessels had been fixed under the original tender negotiations and they were not changed. We understand that the parties sought advice from UK lawyers, Watson Farley Williams, as to the profit that K-Euro ought to be making for acting as the disponent owner, and that the advice was that, in addition to a significant management fee, a profit of 10% of the estimated operating expenses would be satisfactory. We assume that that margin would be achieved by having set the bareboat rent at a low enough level to generate the margin, because there was no way in which the time charter rentals could have been increased in order to fund the profit margin.

The changes in 2006

22. During the construction period of the two vessels, two developments occurred in relation to K-Euro's business. One was that there was a very considerable expansion of its activity, with the company operating and managing a number of vessels in its expanding bulk and gas division.

23. The other development was that, with a shortage of supply of LNG carriers, it was realised that increases in the manning costs of such vessels would lead to K-Euro suffering substantial losses once the vessels had been delivered, rather than making profits as had been projected. This led to discussions between the shareholders in the Northern LNG companies ("the Snøhvit Sponsors") and K-Euro as to how to deal with the changed circumstances. One of the outcomes of those discussions (others of which we shall refer to later) was that the Northern LNG companies agreed to reduce the bareboat charter rentals for a period. This both benefited K-Euro and alleviated the concern of the Snøhvit Sponsors that losses incurred by K-Euro could put at risk the long-term flow of rental to the Northern LNG companies, and so to Lloyds Leasing.

24. We also understand that security requirements in the documentation relating to the two vessels were inhibiting in some way other business being conducted by K-Euro.

25. In response to these various difficulties, there was a major reorganisation of K-Euro's business in 2006 very shortly before the delivery of the two vessels. As a result, all activities of K-Euro that were unrelated to the time chartering

of the two vessels to the Snøhvit Sellers were transferred to other K-Line companies.

26. Whilst it had previously been the intention that K-Euro would not only supply the vessels on a time charter basis to the Snøhvit Sellers, but also undertake itself the manning and maintenance of the two vessels, this plan was also changed. K-Euro retained the contractual obligation to supply, man and maintain the ships, but it contracted with another K-Line company (referred to as K-LNG) for that company to deal with the manning and maintenance on K-Euro's behalf.

27. The next very material change was that the Snøhvit Sponsors (i.e. the shareholders in the two Northern LNG companies) subscribed for A and B shares in K-Euro, the percentages of A shares, following the subscription, matching the percentages of shares held by each of the Snøhvit Sponsors in Northern LNG I, and the percentages of B shares, following the subscription, matching the percentages of shares held by each of the Snøhvit Sponsors in Northern LNG II. We also understand that the Snøhvit Sponsors advanced loans to K-Euro, and agreed to reduce the bareboat charter rentals. Our impression is that, in the event, K-Euro has generally made small profits or small losses, and has probably not achieved the profit margins that were anticipated at the outset.

28. The final two changes to mention in relation to the 2006 reorganisation are, first, that the name of K-Euro was changed to Polar LNG Shipping (UK) Limited and, secondly, that another company was formed to protect the K-Euro name. Throughout this decision we will continue to refer to K-Euro by its original name.

The appeal to the FTT

29. On 29 April 2009 HMRC amended Lloyds Leasing's corporation tax self-assessment return for the year ended 30 September 2006 on the basis that the company was not entitled to claim capital allowances in respect of its expenditure on the LNG carriers. The amendment served to increase the corporation tax payable by £6,278,877.

30. Lloyds Leasing appealed against the amendment, and the FTT allowed the appeal. Its overall conclusion was that Lloyds Leasing was entitled to claim capital allowances in relation to the vessels.

The issues

31. The four issues that the FTT dealt with, and that we must now address, are as follows:

Issue 1: The first issue is whether K-Euro is responsible for defraying all, or substantially all, expenses in connection with the vessels under the time charter throughout the charter period, within the meaning of section 123(1) of the CAA.

The FTT decided this issue in favour of Lloyds Leasing.

Issue 2: The second issue is whether K-Euro lets the vessels on charter in the course of a trade which consists of or includes operating ships, within the meaning of section 123(1) of the CAA.

This issue was again decided by the FTT in favour of Lloyds Leasing.

Issue 3: The third issue is whether (because section 123(4) of the CAA refers to the objective of obtaining writing-down allowances determined without regard to section 109 of the CAA (which denies 25% allowances but allows 10% allowances instead where there is overseas leasing and no qualifying purpose)) section 123(4) can apply in the circumstances where section 110 (rather than section 109) of the CAA is in point, namely where there is overseas leasing and no qualifying purpose so that the taxpayer is entitled to no allowances instead of 10% allowances.

The FTT decided this issue in favour of HMRC.

Issue 4: The fourth issue (if Issue 3 is determined so that in principle section 123(4) of the CAA can apply) is whether the main object, or one of the main objects, of any transaction or series of transactions which includes the letting of the vessels on charter was to obtain the 25% writing-down allowances claimed by Lloyds Leasing.

The FTT decided this issue in favour of Lloyds Leasing.

32 We should make it clear that, in conformity with their original practice (in contrast to a changed practice introduced in 2005), HMRC eventually conceded (after judicial review proceedings were initiated) that all these various requirements should be considered only in relation to the final leases, in other words the time charters granted to the Snøhvit Sellers.

The Upper Tribunal's role

33. When considering the criticisms of the Decision that are advanced, it is important to have in mind the limited circumstances in which it is appropriate for the Upper Tribunal to interfere with factual and evaluative decisions.

34. Guidance as to the grounds on which factual findings can be challenged on appeal is to be found in *Edwards v Bairstow* [1956] AC 14. Viscount Simonds there said (at 29) that a finding of fact should be set aside if it

appeared that the finding had been made "without any evidence or upon a view of the facts which could not reasonably be entertained". Lord Radcliffe (at 35) quoted a passage from a judgment of Lord Normand in which the latter had said that an appellate Court could intervene if the lower tribunal had "misunderstood the statutory language" or had "made a finding for which there is no evidence or which is inconsistent with the evidence and contradictory of it". Lord Radcliffe went on to say this (at 36) about the position where "the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal":

> "I do not think that it much matters whether this state of affairs is described as one in which there is no evidence to support the determination or as one in which the evidence is inconsistent with and contradictory of the determination, or as one in which the true and only reasonable conclusion contradicts the determination. Rightly understood, each phrase propounds the same test. For my part, I prefer the last of the three, since I think that it is rather misleading to speak of there being no evidence to support a conclusion when in cases such as these many of the facts are likely to be neutral in themselves, and only to take their colour from the combination of circumstances in which they are found to occur."

35. The decision of the Court of Appeal in *Procter & Gamble UK v Revenue and Customs Commissioners* [2009] STC 1990, where the question was whether "Pringles" were standard-rated rather than zero-rated for VAT purposes because they fell within Item 5 of the "Excepted items" in Group 1 of Schedule 8 to the Value Added Tax Act 1994, indicates other limits on the circumstances in which an appellate court should intervene. Jacob LJ said (in paragraph 9):

> "Often a statutory test will require a multi-factorial assessment based on a number of primary facts. Where that it so, an appeal court (whether first or second) should be slow to interfere with that overall assessment—what is commonly called a value-judgment."

Further, Jacob LJ (like Mummery and Toulson LJJ – see paragraphs 48 and 73) drew attention to the fact that the appeal before the Court was from a specialist tribunal. Jacob LJ observed (in paragraph 11):

> "It is also important to bear in mind that this case is concerned with an appeal from a specialist tribunal. Particular deference is to be given to such tribunals for Parliament has entrusted them, with all their specialist experience, to be the primary decision maker; see per Baroness Hale in *AH (Sudan) v Secretary of State for the Home Department ....*"

Jacob LJ described the issue for an appellate Court in these terms (in paragraph 22):

> "So one can put the test for an appeal court considering this sort of classification exercise as simply this: has the fact finding and evaluating tribunal reached a conclusion which is so unreasonable that no reasonable tribunal, properly construing the statute, could reach?"

For his part, Mummery LJ said (in paragraph 74):

> "I cannot emphasise too strongly that the issue on an appeal from the tribunal is not whether the appellate body agrees with its conclusions. It is this: *as a matter of law, was the tribunal entitled to reach its conclusions?*"

36. On the other hand, comments made in the recent Supreme Court decision in *R (Jones) v First-tier Tribunal (Social Entitlement Chamber)* [2013] UKSC 19, [2013] 2 WLR 1012 indicate that the distinction between issues of law and of fact is not necessarily clear-cut. Lord Carnwath, quoting from an article he had written, floated the idea that an expert appellate tribunal "should be permitted to venture more freely into the 'grey area' separating fact from law, than an ordinary court", with "issues of law" in this context being "interpreted as extending to any issues of general principle affecting the specialist jurisdiction" (see paragraph 46). Lord Hope observed (at paragraph 16) that "[a] pragmatic approach should be taken to the dividing line between law and fact, so that the expertise of tribunals at the first tier and that of the Upper Tribunal can be used to best effect". It is to be noted, however, that the Supreme Court ultimately concluded that the FTT had made no error of law and, hence, that the Courts were not justified in interfering with its decision.

Issue 1 (Responsibility for expenses)

37. For a ship to be used for a "qualifying purpose", it must, among other things, be let on charter by a person who is (within the meaning of section 123(1)(b) of the CAA):

> "responsible for navigating and managing the ship throughout the period of the charter and for defraying –
> (i) all expenses in connection with the ship throughout that period, or
> (ii) substantially all such expenses other than those directly incidental to a particular voyage or to the employment of the ship during that period".

38. HMRC's case is that this requirement is not satisfied in the present case. According to HMRC, K-Euro is not responsible for "defraying" either all

expenses in connection with the ships chartered to the Snøhvit Sellers or substantially all such expenses other than those directly incidental to a particular voyage or to the employment of the ships during the period of the charters.

39. HMRC's submissions on this part of the case were presented to us by Mr Raymond Hill, who appeared with Mr David Ewart QC and Miss Stephanie Barrett. Mr Hill focused attention on insurance costs. As indicated above, the hire payable under the time charterparties consists of a "Capital Element" and an "Operating Cost Element". The latter itself has several components, one of which is described as "Pass-Through Operating Cost". This category is stated to cover:

> "all premiums of
> (iii) Hull and Machinery (including War Risks) Insurance
> (iv) Loss of Hire (including War Risks) Insurance
> (v) Protection and Indemnity Insurance
> (vi) Social Responsibility Insurance".

The hire for the vessels thus covers the costs of providing the insurance in question.

40. These provisions mean, Mr Hill argued, that K-Euro is not responsible for defraying the relevant insurance premiums. While it might incur legal liability to pay the insurers, it is entitled to pass the cost on to the Snøhvit Sellers, and so it is they who are responsible for defraying that expense. It follows (so it is said) that K-Euro cannot be considered to have the requisite responsibility as regards either of the chartered vessels for "all expenses in connection with the ship throughout [the period of the charter]" or "substantially all such expenses other than those directly incidental to a particular voyage or to the employment of the ship during that period".

41. One of Lloyds Leasing's answers is based on section 123(1)(b)(ii)'s use of the word "substantially". Mr Jonathan Peacock QC, who appeared with Mr Michael Ripley for Lloyds Leasing, submitted that it does not matter whether K-Euro is considered to be responsible for defraying the insurance costs since it would anyway be responsible for defraying "substantially all" the relevant expenses. In this regard, we were told that insurance costs typically represent some 6-8% of the total expenses.

42. Mr Hill's position was that it is not enough that a ship operator bears, say, 90% of the relevant expenses. According to Mr Hill, the requirements of section 123(1) will not be satisfied unless a ship operator bears every relevant expense (subject, possibly, to a de minimis exception). The submission was put in these terms in HMRC's skeleton argument:

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> "Section 123(1)(b)(i) requires the relevant person to defray 'all expenses in connection with the ship throughout the period'. The use of the word 'substantially' in section 123(1)(b)(ii) cannot mean that defraying the majority of the expenses in connection with the ship during the relevant period is sufficient for the ship to be used for a qualifying purpose. Otherwise, section 123(1)(b)(i) would have no application. Therefore, the word 'substantially' here must be a reference to the defraying of the entirety of the expenses in connection with the ship, other than those excluded by the remainder of section 123(1)(b)(ii) – 'those directly incidental to a particular voyage or to the employment of the ship during that period'."

43. The FTT said this about this aspect of the case:

15 20 25

> "[309] The phrase is 'all … or substantially all'. That does, it seems to us, look essentially to the quantum (or proportion of quantum) of the expenses rather than to their nature: 'all' (certainly with regard to a group of expenses) is the totality or aggregate without any concept of nature or characteristic, and where that totality is qualified to indicate something less than the totality or aggregate it requires clear language to introduce the concept of nature or characteristic to show that the totality is to be qualified by reference to such concepts. 'Substantially all' does not do that…. The purpose of the provision is to enable the qualifying use test to apply notwithstanding that some of the ship operating costs—a small proportion relative to all of them—are met by the user of the ship: the nature of the costs which the user meets is not a factor.
>
> [310] In the present case in each year to date K-Euro has been responsible for defraying more than 90% of the ship operating costs even if it is the case that it is not responsible for defraying those costs which relate to insurance. We consider that it has therefore been responsible for defraying substantially all expenses in connection with the vessels throughout the charter period, other than those directly incidental to a particular voyage or to the employment of the ship during that period."

30 35

44. We agree with the FTT that the qualifying use test can potentially be satisfied even if the operating costs are not entirely met by the ship operator. Our reasons include these:

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(a) The words "substantially all" naturally suggest "*nearly* all". They imply that it need not matter that costs are, to an insubstantial extent, defrayed by someone other than the ship operator;

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(b) The contrast between section 123(1)(b)(i)'s reference to "all expenses" and section 123(1)(b)(ii)'s "substantially all … expenses"

tends to confirm that something less than "all" will suffice in the context of section 123(1)(b)(ii);

(c) Every word of an enactment is presumed to have been put there for a purpose (see Bennion on Statutory Interpretation, 5th. ed., at page 1157). On HMRC's construction of section 123(1)(b)(ii), however, the word "substantially" would be otiose. It would add nothing to the subsequent exclusion of expenses "directly incidental to a particular voyage or to the employment of the ship during [the period of the charter]";

(d) HMRC would seem to be correct that, on Lloyds Leasing's interpretation of section 123(1)(b)(ii), section 123(1)(b)(i) would have no application. Exactly the same is, however, true of HMRC's own interpretation of section 123(1)(b)(ii). Whichever way "substantially" is construed, we cannot see there can be any situation in which section 123(1)(b)(i) would apply but section 123(1)(b)(ii) would not;

(e) It is not inherently implausible that Parliament should have thought it good enough for a ship operator to be responsible for defraying nearly all the expenses in question rather than every single one.

45. Section 123(1)'s origins are noteworthy in this context. They can be traced back to section 64(5) of the Finance Act 1980. As originally drafted, the clause that became section 64(5) referred to "all expenses in connection with the ship … or all such expenses other than those directly incidental to a particular voyage". Had it been enacted in that form, the clause would surely have carried the meaning that HMRC contend that the present section 123(1)(b) has. However, the clause was amended by the insertion of the word "substantially" before the second "all". That was doubtless on the basis that the extra word would affect the meaning.

46. Mr Hill accepted that, if we rejected HMRC's construction of "substantially all" (as we do), section 123(1)(b)(ii) would be satisfied regardless of whether K-Euro is "responsible … for defraying" the insurance costs within the meaning of the provision. That being so, we do not need to decide whether K-Euro is so responsible, and we do not express any view on the point. Our conclusions on the meaning of "substantially all" are enough to dispose of Issue 1 in Lloyds Leasing's favour.

Issue 2 (Trading)

47. A ship cannot be used for a "qualifying purpose" within section 123(1) of the CAA unless it is:

> "let on charter in the course of a trade which consists of or includes operating ships".

48. Issue 2 is concerned with whether this condition is satisfied as regards the LNG carriers chartered to the Snøhvit Sellers. The question is whether the vessels are let by K-Euro "in the course of a trade which consists of or includes operating ships", as section 123(1) requires.

49. The FTT observed in paragraph 321 of the Decision that the question "falls to be answered by reference to K-Euro's activities in the period beginning with the delivery of the vessels (strictly, the delivery of the first of the vessels, in February 2006)". HMRC expressly endorsed that approach, and Lloyds Leasing did not suggest otherwise.

50. HMRC's case is essentially that, whatever the position may have been earlier, K-Euro was not trading by the time the vessels were delivered in 2006. The vessels cannot therefore (so it is argued) have been let "in the course of a trade which consists of or includes operating ships".

51. HMRC relied in support of its submissions on the decision of the House of Lords in *F.A. & A.B. Ltd v Lupton* [1972] AC 634. The FTT said this (in paragraph 324 of the Decision) about the principles to be derived from the *Lupton* case:

> "There is no significant difference between the parties as to the guidance we should derive from case law when considering whether or not K-Euro is trading. From the line of cases which have analysed and applied *FA & AB Ltd v Lupton* it is clear that the proper approach is to look to the purported trading transaction—at what actually happens—and then discern whether, in its form and character, it is a trading transaction. It is irrelevant that the transaction was entered into with the intention of securing a tax benefit, such as obtaining capital allowances for expenditure incurred, unless that results in the transaction so lacking commerciality that it cannot be said to have the form and character of a trading transaction."

We did not understand HMRC to quarrel with this summary of the law.

52. The FTT concluded, rejecting HMRC's submissions, that K-Euro "lets the vessels on charter in the course of a trade which consists of or includes operating ships" (see paragraph 337 of the Decision). Its reasoning appears from the following passage from the Decision:

> "[334] … [W]e have no hesitation in concluding that K-Euro's activities have the form and characteristics of trading. Both with regard to the operation of the vessels and the broader business of which the operation of the vessels formed a part, it was engaged on its own account in a serious, substantial and properly managed business endeavour. That endeavour was intended to result in a

> profit which reflected both a management fee and a mark-up on operating costs, and thus a profit which accorded with K-Euro's position as an operator rather than a manager, and which also took account of the risks of that position. As it happened those risks eventually proved to be real: certain market conditions moved against K-Euro (especially as to the cost of manning the vessels) and it became clear that losses would result once the chartering arrangements took effect on delivery of the vessels. It therefore cannot be said that the trading nature of those activities falls to be disregarded—that in fact they cease to be trading activities—because they lack commerciality.
>
> [335] The only remaining question is whether there should be a different conclusion having regard to the post-2006 reorganisation of K-Euro's business and share capital, since it was in this pared-down form that K-Euro actually embarked upon the operation of the vessels. We think not. For the reasons we have already given, the pre-reorganisation position must inform the nature of the post-reorganisation activities of K-Euro. Further, K-Euro retained the obligations to operate the vessels after the reorganisation to the same extent as before, and discharged those obligations at its own cost. That it discharged those obligations through the management agency provided by K-LNG supplying the necessary services to K-Euro cannot change the form and characteristics of the ship-operating activities undertaken by K-Euro. It does not matter whether the 20 or more individuals who, by Mr Misaki's evidence, are variously engaged in the variety of activities required to operate the vessels, are directly engaged by K-Euro, or whether instead K-Euro has the benefit of their endeavours by means of the services and management contract it has entered into with K-LNG.
>
> [336] The only material difference consequent upon the 2006 reorganisation is that the activities of K-Euro have been reduced so that its sole activity is the operation of the vessels: that activity is no longer part of a wider business enterprise, and on any basis K-Euro's trading activities must be regarded as shrunken. Have they been shrunken to the point that they no longer comprise a trade? We do not think that this is the case. The operation of a single vessel is in itself a substantial business venture. The audited report and financial statements of K-Euro for the year ended 31 December 2006 indicate the size of the business retained by K-Euro by reference to its turnover. It is the case that it retains a trade by virtue of chartering and operating the vessels alone."

53. Mr Hill argued that the FTT's conclusions in this respect were wrong. He submitted that the FTT failed to focus on the substance of the arrangements from 2006 onwards and attached too much importance to the position in earlier years. Among other things, Mr Hill pointed out that following the

2006 reorganisation management of the vessels was delegated to K-LNG, K-Euro had only one (part-time) employee and he was a partner in a City law firm. Mr Hill suggested that, tax considerations apart, the parties could and would have achieved their objectives by novating the time charters to the Northern LNG companies rather than by changing K-Euro's shareholdings. The fact that K-Euro was instead kept in the structure as a "husk" must have had a fiscal purpose. In the light of the *Lupton* case, the FTT ought to have concluded that K-Euro was not trading by 2006 if it ever had been.

54. Mr Peacock, on the other hand, maintained that the FTT's conclusions are not open to challenge. Those conclusions, he argued, are rooted in findings of fact for which there was evidence. More specifically, he relied on the FTT's finding that "[t]he operation of a single vessel is in itself a substantial business venture" (paragraph 336 of the Decision) and noted that the functions delegated to K-LNG did not extend to matters of commercial management and that K-Euro continued to bear the costs of operating the vessels (in which connection, we were referred to paragraph 257 of the Decision). He also stressed that the time charterparties had been entered into, and novated to K-Euro, before the 2006 reorganisation, and that the arrangements as between K-Euro and the Snøhvit Sellers did not change in 2006. With regard to the importance Mr Hill attached to K-Euro's retention in the structure after the reorganisation, Mr Peacock said that it was necessary to look at what K-Euro actually did, not at what other options were available to it. Mr Peacock also pointed out that K-Euro was taxed as a trading company in the years after 2006.

55. In our view, the FTT was justified in concluding that K-Euro lets the vessels in the course of a trade which consists of or includes operating ships. HMRC's complaint is not about the FTT's interpretation of the law as such but about its application of the law to the facts. That being so, the question is not whether we would ourselves have arrived at the conclusion the FTT reached, but whether there was evidence to support that conclusion or, in other words, whether the conclusion was unreasonable or irrational. In our opinion, there was a sufficient basis for the FTT's view.

56. In the first place, there was, as we see it, ample evidence that K-Euro was trading before the 2006 reorganisation. Details of its activities up to 2006 are given in paragraphs 201-216 of the Decision. They are reflected in the company's 2005 accounts, which (as is explained in paragraph 216 of the Decision) disclosed turnover for the year of £42.633 million, gross profit of £18.854 million, net profit of £3.657 million and 163 employees. The accounts explained:

> "The principal activity of the company during the year was that of general shipping agents for containerships and car carriers throughout Europe as well as operation of bulk vessels and ship management of

LNG vessels throughout the world. The company's bulk division had eight bulk vessels in its fleet as at the end of the year."

57. Did the position change in 2006? As the FTT recognised (paragraph 322 of the Decision), K-Euro became a "quite different animal": it shed most of its activities, outsourced the manning and maintenance of the vessels chartered to the Snøhvit Sellers and was left with a solitary part-time employee from a law firm. None of this, however, is necessarily inconsistent with continued trading: a company can trade even though it has delegated the performance of obligations to a third party and even though it does not have many (or any) employees of its own. Nor need the fact that a company follows the wishes of an associated company be a bar to its trading. Moreover, the time charters to the Snøhvit Sellers were unchanged, and it continued to be in K-Euro's interests to minimise the cost of performing its obligations under the time charters so that it could trade as profitably as possible. In practice, K-Euro has recorded small profits and losses and been taxed accordingly. In all the circumstances, the FTT was, as it seems to us, justified in finding that K-Euro was still trading regardless of whether the arrangements would have been structured differently but for fiscal considerations.

58. The present case is very different from *Lupton*. In *Lupton*, the issue was whether a trading loss had arisen from transactions involving "truly strange arrangements" (in Lord Morris' words) that had been entered into pursuant to "a raid on the Treasury using the technicalities of revenue law and company law as the necessary weapons" (in words of Lord Donovan). In contrast, there can be no question of the time charterparties having been "so affected or inspired by fiscal considerations that the shape and character of the transaction is no longer that of a trading transaction" (to quote Lord Morris in *Lupton*): they reflected the 2001 tender process, and the 2006 reorganisation was not yet in prospect when they were entered into or even when they were novated to K-Euro in 2002. Even supposing that tax considerations could be said to account for the chartering being undertaken through K-Euro (as opposed to any other entity), it would by no means follow that K-Euro was not trading. Fiscal concerns might be said to explain, at most, why it was K-Euro that was doing the trading.

59. In short, we do not accept HMRC's submissions on Issue 2.

Issue 3 (Applicability in principle of section 123(4))

60. Issue 3 relates to the construction of section 123(4) of the CAA. It may be as well to set out this provision again at this point:

> "(4) Subsections (1) and (2) do not apply if the main object, or one of the main objects–
>
> (a) of the letting of the ship … on charter,

> (b) of a series of transactions of which the letting of the ship … on charter was one, or
> (c) of any of the transactions in such a series,
>
> was to obtain a writing-down allowance determined without regard to section 109 (writing-down allowances at 10%) in respect of expenditure incurred by any person on the provision of the ship or aircraft."

Section 123(4) thus operates where a main object of a relevant transaction was "to obtain a writing-down allowance determined without regard to section 109 (writing-down allowances at 10%)".

61. Both sides referred us to section 123(4)'s antecedents. These extend back to the Finance Act 1980. Section 64(1) of that Act provided that no first-year allowance was to be made in respect of expenditure on the provision of machinery or plant for leasing unless the machinery or plant was to be used for a "qualifying purpose". Under section 64(5), from which section 123(1) of the CAA is derived, a ship could potentially be used for a "qualifying purpose" if let on charter in the course of a trade by a UK-based person. However, section 64(6A), which was added to the 1980 Act in 1982, barred section 64(5) from applying if:

> "the main object, or one of the main objects, of the letting of the ship … on charter, or of a series of transactions of which the letting on charter was one, or of any of the transactions in such a series was to obtain a first-year allowance in respect of expenditure incurred on the provision of the ship…."

62. The Finance Act 1984 provided for the abolition of first-year allowances. At this stage, the words "writing-down allowance of an amount determined without regard to section 70(2) of the Finance Act 1982" were substituted for "first-year allowance" in section 64(6A) of the 1982 Act. Section 64(6A) thus operated where:

> "the main object, or one of the main objects, of the letting of the ship … on charter, or of a series of transactions of which the letting on charter was one, or of any of the transactions in such a series was to obtain a writing-down allowance of an amount determined without regard to section 70(2) of the Finance Act 1982 in respect of expenditure incurred on the provision of the ship…."

Section 70(2) of the 1982 Act served to reduce writing-down allowances from 25% to 10% on assets used for overseas leasing other than "protected leasing".

63. The earlier provisions were consolidated with the enactment of the Capital Allowances Act 1990. Section 42 of the 1990 Act provided, so far as relevant, as follows:

> "(1) This section has effect with respect to expenditure on the provision of machinery or plant for leasing where the machinery or plant is at any time in the requisite period used for the purpose of being leased to a person who—
>
> (a) is not resident in the United Kingdom, and
> (b) does not use the machinery or plant for the purposes of a trade carried on there or for earning profits or gains chargeable to tax by virtue of section 830(4) of the principal Act,
>
> and where the leasing is neither short-term leasing nor the leasing of a ship, aircraft or transport container which is used for a qualifying purpose by virtue of section 39(6) to (9).
>
> (2) In their application to expenditure falling within subsection (1) above, sections 24, 25 and 26 as they have effect—
>
> (a) in accordance with section 41, or
> (b) in accordance with section 80, or
> (c) in accordance with section 34, or
> (d) with respect to any motor car to which section 35(1) applies, or
> (e) with respect to machinery or plant to which section 61 applies,
>
> shall have effect, subject to subsection (3) below, as if the reference in section 24(2) to 25 per cent. were a reference to 10 per cent.
>
> (3) No balancing allowances or writing-down allowances shall be available in respect of expenditure falling within subsection (1) above if the circumstances are such that the machinery or plant in question is used otherwise than for a qualifying purpose and—
>
> (a) there is a period of more than one year between the dates on which any two consecutive payments become due under the lease; or
> (b) any payments other than periodical payments are due under the lease or under any agreement which might reasonably be construed as being collateral to the lease; or
> (c) disregarding variations made under the terms of the lease which are attributable to—

5 10 15 20 25 30 35 40 45

(i) changes in the rate of corporation tax or income tax, or
(ii) changes in the rate of capital allowances, or
(iii) changes in any rate of interest where the changes are linked to changes in the rate of interest applicable to inter-bank loans, or
(iv) changes in the premiums charged for insurance of any description by a person who is not connected with the lessor or the lessee,

any of the payments due under the lease or under any such agreement as is referred to in paragraph (b) above, expressed as monthly amounts over the period for which that payment is due, is not the same as any other such payment expressed in the same way; or

(d) either the lease is expressed to be for a period which exceeds 13 years or there is, in the lease or in a separate agreement, provision for extending or renewing the lease or for the grant of a new lease so that, by virtue of that provision, the machinery or plant could be leased for a period which exceeds 13 years; or

(e) at any time the lessor or a person connected with him will, or may in certain circumstances, become entitled to receive from the lessee or any other person a payment, other than a payment of insurance moneys, which is of an amount determined before the expiry of the lease and which is referable to a value of the machinery or plant at or after that expiry (whether or not the payment relates to a disposal of the machinery or plant)."

64. The expression "qualifying purpose" was explained in section 39 of the 1990 Act. Section 39(6) stated:

> "Without prejudice to subsections (1) to (5) above but subject to subsection (8) below, a ship is also used for a qualifying purpose at any time when it is let on charter in the course of a trade which consists of or includes operating ships if—
>
> (a) the person carrying on the trade is resident in the United Kingdom or carries on the trade there, and
>
> (b) that person is responsible as principal (or appoints another person to be responsible in his stead) for navigating and managing the ship throughout the period of the charter and for defraying all expenses in connection with the ship throughout that period or substantially all such expenses other than those directly incidental to a particular voyage or to the employment of the ship during that period."

Section 39(8) provided:

> "Subsection (6) above does not apply if the main object, or one of the main objects, of the letting of the ship or aircraft on charter, or of a series of transactions of which the letting on charter was one, or of any of the transactions in such a series was to obtain—
>
> (a) if the expenditure in question is old expenditure, a first-year allowance, or
> (b) if the expenditure in question is new expenditure, a writing-down allowance of an amount determined without regard to section 42(2),
>
> in respect of expenditure incurred on the provision of the ship or aircraft whether that expenditure was incurred by the person referred to in subsection (6)(a) above or some other person."

65. Chadwick LJ said this about section 42(3) of the 1990 Act in *BMBF (No 24) Ltd v IRC* [2003] EWCA Civ 1560, [2004] STC 97 (at paragraph 39):

> "Section 42(3) of the 1990 Act is in point where each of three conditions is satisfied: (i) the expenditure (in respect of which allowances would otherwise be available) is expenditure within s 42(1); (ii) the circumstances are such that the machinery or plant (on the provision of which the expenditure has been incurred) is used 'otherwise than for a qualifying purpose'; and (iii) one or more of the features described in paras (a) to (e) are present. If condition (i) is met, but either of conditions (ii) or (iii) are not met, then s 42(3) is not applicable. In such a case, the provisions of s 42(2) apply so as to reduce the amount of the writing-down allowances from 25% to 10%."

66. Mr Peacock argued that section 123(4) of the CAA (which has replaced section 39(8) of the 1990 Act) can be seen to be concerned with transactions where a main object was to avoid the restriction to a 10% rate imposed by section 109 of the Act. There being no reference in section 123(4) to section 110, section 123(4) does not (so Mr Peacock maintained) cover cases where the main object was instead to obtain a capital allowance where there would otherwise have been none at all. This was said to reflect the original role of section 64(5) of the Finance Act 1980 in limiting the assets which would give rise to 100% allowances rather than 25% allowances. In the present case, HMRC have never suggested that any of the relevant transactions was designed to avoid the 10% rate for which section 109 provides: since the head leases were for more than 13 years, there was never any question of section 109 applying. Section 123(4) cannot therefore be in point.

67. For his part, Mr Ewart placed considerable reliance on the provisions of the Capital Allowances Act 1990. Basing himself in part on Chadwick LJ's comments in the *BMBF* case, Mr Ewart submitted that subsections (1) and (2) of section 42 of the 1990 Act were stepping-stones to subsection (3). Section 39(8) of the Act, in referring to an object of obtaining a writing-down allowance "without regard to section 42(2)", incorporated the conditions in section 42(1), with the result that one of the objects referred to in section 39(8) was circumventing the condition now to be found in section 123(1) of the CAA. The structure of the provisions was altered when they were re-written in 2001, but the changes were not intended to alter their substantive legal effect.

68. The FTT took the view that the position for which Lloyds Leasing was contending was absurd (paragraph 357 of the Decision) and was persuaded by Mr Ewart that section 123(4) of the CAA should be construed (see paragraph 363):

> "having regard to the provisions of which it is a re-statement, so that the reference to section 109 CAA 2001 does not have the limiting or restricting effect which on its face it has".

The FTT continued (in paragraph 364):

> "We can arrive at the same conclusion by a different, and equally valid, route. The expression we are concerned with is 'determined without regard to section 109'. The phrase 'without regard to' means 'without taking into account', or 'without heed to' the matter in question. If no account is to be taken of the position under section 109 CAA 2001, it does not matter whether section 109 could or could not apply in this context, because it is immaterial. If what the taxpayer sought to obtain was a 25 per cent writing-down allowance then that does not involve an allowance that is determined under section 109 CAA 2001 – section 109 CAA 2001 is not in point. If section 109 CAA 2001 is not in point either because it could not apply or because it could only apply if 25 per cent allowances were not available, then the exercise of determining whether or not the taxpayer sought to obtain a 25 per cent writing-down allowance can be carried out without regard to section 109 CAA 2001."

The FTT therefore concluded (in paragraph 366 of the Decision) that:

> "section 123(4) CAA 2001 can apply in the circumstances where section 110 (rather than section 109) CAA 2001 is in point, and can therefore in principle apply to the circumstances of the Appellant's claim for writing-down allowances for its expenditure on the provision of the Vessels."

69. We agree with the FTT's conclusion. As the FTT pointed out (in paragraph 357), "[t]here can be no grounds of logic or policy … to limit the application of the 'main objects' anti-avoidance provision to the circumstances where the taxpayer's claim (if he is unable to show a 'qualifying purpose') is to 10 per cent allowances and to let the more 'mischievous' taxpayer (who is denied all allowances if he is unable to show a 'qualifying purpose') escape its clutches". In our view, all that section 123(4) requires is that a main object of a relevant transaction was to obtain a writing-down allowance other than an allowance such as section 109 provides for. Section 123(4) does not say – as it could have – that the subsection applies where a main object was to prevent a writing-down allowance being reduced to the rate laid down in section 109. As it is, the focus is rather on whether there was an attempt to obtain an allowance determined otherwise than by reference to section 109. In the circumstances, the subsection will apply where a main object was to obtain a 25% writing-down allowance regardless of whether a 10% allowance (under section 109) could have been an alternative: either way, the parties will have been seeking a "writing-down allowance determined without regard to section 109" since section 109 would have played no part in the determination of the allowance.

Issue 4 (Main object to obtain a writing-down allowance)

70. The fourth issue in this appeal was the one most strenuously advanced by HMRC. It poses the question of whether "the main object, or one of the main objects – (a) of the letting of the ship ... on charter, (b) of a series of transactions of which the letting of the ship … on charter was one, or (c) of any of the transactions in such a series, was to obtain a [25%] writing-down allowance … in respect of expenditure incurred by any person on the provision of the ship". It presupposes all the conclusions that we have already reached. It thus assumes that the requirements of section 123(1) were duly satisfied. It also proceeds on the basis of our conclusion in relation to the third issue, namely, that as a matter of construction the section 123(4) test can operate when section 110 of the CAA would be in point, precluding all allowances, and not just when section 109 would reduce writing-down allowances to 10%.

71. HMRC's contention before the FTT, and again their contention in the appeal before us, was that the transactions that fell foul of that "main object" test were the grant by the Northern LNG companies of the bareboat charters to K-Euro and the novation of the time charters, initially granted by K-Line to the Snøhvit Sellers, from K-Line to K-Euro.

The substance of the Decision

72. Lloyds Leasing had contended (essentially on behalf of K-Line) that K-Line's objects in promoting the transactions just mentioned were fundamentally commercial. K-Line was keen to expand its European and

Atlantic region business, and K-Euro was an ideal company through which to pursue that strategy. K-Euro's business was built up from 2002 onwards as part of that commercial strategy. As regards the specific transactions at issue, there were business reasons for K-Line wishing to insert K-Euro into the chain of leases. While it was clear that K-Euro could theoretically have simply managed the LNG carriers, with the Northern LNG Companies time chartering them directly to the Snøhvit Sellers, K-Line preferred there to be a direct relationship between K-Euro and the Snøhvit Sellers. Inserting K-Euro into the leasing chain had commercial implications. It meant that K-Euro incurred real risks and secured certain benefits. It was, moreover, the structure that K-Line chose for K-Euro, and it was not appropriate for HMRC to suggest that some other structure, with different commercial implications, should have been selected.

73. HMRC's fundamental case was that K-Euro had been inserted into the chain of leases because that step was required to enable Lloyds Leasing to claim the allowances. At its most extreme, HMRC's case was that the business of K-Euro was progressively expanded, from 2002 onwards, principally to bolster the case that K-Euro was a "bona fide UK shipping company", the paraphrase adopted by the parties and others for the status of a company such as K-Euro that would or might undermine any HMRC claim that the company was inserted into the lease chain for at least one main reason geared to the obtaining of the capital allowances.

74. The FTT decided this crucial issue in favour of Lloyds Leasing. We shall need to consider the basis on which it arrived at its view further in due course. For present purposes, it is sufficient to say that it concluded that obtaining the capital allowances was not a main object of the transactions. "In terms of priority or hierarchy, [the object of obtaining the allowances] was subservient to, or of lesser importance than, achieving the commercial purposes of the relevant transactions" (paragraph 427 of the Decision).

The contentions in the appeal before us

75. HMRC contended that we can overturn the FTT's decision on the fourth issue for two reasons: first, because the FTT failed to apply the correct legal test when determining whether "the main object, or one of the main objects" of the relevant transactions was to obtain writing-down allowances and, secondly, because the FTT's decision on the facts was not one it could reasonably have arrived at applying the law correctly. They argued that we should either reverse the Decision or remit the case back to the FTT.

76. Mr Peacock, for Lloyds Leasing, submitted that there is no error of law in the Decision; that even if the Tribunal was wrong in its approach to the context in which section 123(4) should be interpreted, and wrong to adopt his suggestion that one particular authority was relevant, none of this is ultimately relevant. When the FTT came to articulate the relevant test, it

quoted it accurately, and then applied it properly. The FTT's analysis of the facts and the extensive evidence was careful and accurate and, having regard particularly to the very limited circumstances in which it is permissible for factual findings to be overturned on appeal, it is not open to us to interfere with the factual conclusions. Mr Peacock claimed that HMRC had only surveyed the evidence selectively and had sometimes relied on documents that had not been put to witnesses. In any event, the FTT was right in its findings of fact, and its conclusions justified by the evidence.

Comments made by the FTT on the legal test

77. In the course of the Decision, the FTT observed (in paragraph 386) that the relevant statutory regime (of capital allowances) is designed "to encourage taxpayers to make capital expenditure on certain assets (including ships)", so that "section 123(4) ... cannot have been intended to emasculate the incentives available through the capital allowance legislation by reason of section 123(1)". Furthermore the "main object" test should be distinguished from others that addressed "the main object of obtaining some form of tax advantage".

78. Mr Ewart took issue with these remarks, and in our view he was justified in doing so. In the first place, while the capital allowance legislation is in general terms designed to provide an incentive for the acquisition of various assets (by accelerating tax depreciation as against the normal basis of depreciating assets for accounting purposes), section 123 appears in a group of sections designed to reduce, or in the present context to deny, capital allowances for acquisitions of assets that are ultimately leased to non-UK residents, i.e. for "overseas leasing". We accept that section 123 itself is designed to provide a qualification to that policy objective (i.e. still to concede 25% allowances to the parties intended to benefit from section 123), but when the "main object" test clearly qualifies the ambit of the "let-out", and reinstates the clear policy of reducing or denying allowances for overseas leasing, it would be wrong to proceed on the basis that the main object test should be construed narrowly so as not to conflict with the policy objective of the capital allowance legislation in general.

79. A second point concerns the reference to "emasculat[ing] incentives available through the capital allowance legislation by reason of section 123(1)". There would have been no risk of HMRC's contentions in this case undermining the claim for 25% allowances in the situation most obviously designed to benefit from the protection afforded by section 123, viz. that of a UK resident shipping company (whether in a UK or a non-UK group) purchasing a ship outright with a view to time chartering it to an overseas customer. In a case of that kind, 25% allowances would plainly have been available. There would have been no question of a ship being bought without capital allowances being available, so that it could never have been said that any main object of the purchase (or any other related transaction) was to secure such allowances.

80. Mr Ewart also criticised the FTT's approach to one of the authorities to which it was referred, *Barclays Mercantile Industrial Finance Ltd v. Melluish* [1990] STC 314.

81. *Barclays Mercantile Industrial Finance Ltd v. Melluish* concerned a provision (what was then paragraph 3(1)(c) of Schedule 8 to the Finance Act 1971) under which a person was denied a first-year allowance where it appeared in relation to a transaction that:

> "the sole or main benefit which, but for this sub-paragraph, might have been expected to accrue to the parties or any of them was the obtaining of a first-year allowance."

The Inland Revenue contended that this provision barred a finance lessor from claiming first-year allowances in respect of expenditure incurred in purchasing films pursuant to a sale and leaseback financing transaction. The Special Commissioners ruled in favour of the taxpayer, and their decision was upheld by Vinelott J on appeal. At one point in his judgment (343a), Vinelott J said:

> "Paragraph (c) as I see it is aimed at artificial transaction designed wholly or primarily at creating a tax allowance."

82. In the present case, the FTT said (at paragraph 391) that in *Melluish*:

> "In order to claim successfully the allowances in the particular circumstances of the case the taxpayer finance lessor had to satisfy a 'main object' test similar to that faced by [Lloyds Leasing] in this case."

In our view, however, the test that fell to be applied in *Melluish* was very different from that laid down by section 123(4) of the CAA. The provision at issue in *Melluish* focused on "the" sole or main benefit of the transaction. Section 123(4), in contrast, will apply if "one of the main objects" was to obtain a writing-down allowance. It plainly follows that section 123(4) can apply even if the transaction in question had a commercial objective at least as important as obtaining a writing-down allowance. Section 123(4) cannot be restricted to "artificial" transactions "designed wholly or primarily at creating a tax allowance". In the circumstances, we do not think that *Melluish* casts any real light on how section 123(4) should be approached.

83. The FTT also referred to *IRC v Brebner* [1967] 2 AC 18. The provision at issue in that case entitled a taxpayer to discharge a notice served under section 28 of the Finance Act 1960 if he showed, among other things, that none of the relevant transactions:

> "had as their main object, or one of their main objects, to enable tax advantages to be obtained".

Unlike *Melluish*, therefore, the case related to wording very similar to that to be found in section 123(4) of the CAA. It is apparent from the House of Lords decision that what mattered for the purposes of section 28 of the 1960 Act was the parties' subjective intentions: Lord Pearce said (at 27) that "[t]he 'object' which has to be considered is a *subjective* matter of intention" and Lord Upjohn (with whom Lord Reid agreed) observed (at 30) that "the question whether one of the main objects is to obtain a tax advantage is subjective, that is, a matter of the intention of the parties". As Mr Ewart and Mr Peacock both accepted, section 123(4) of the CAA must equally look to what was subjectively intended. It is also noteworthy that the House of Lords considered the application of section 28 of the 1960 Act to the particular case to give rise to a question of fact: see Lord Pearce at 26 and Lord Upjohn at 30.

84. The FTT referred to *Brebner* in paragraph 409 of the Decision in these terms:

> "It is questionable whether it does in any event assist the Commissioners' case to say, in effect, 'They could have done it differently', having regard to Lord Upjohn's comment in the *Brebner* case. But it is even less tenable to say, 'They could have done it differently, notwithstanding that it would have given rise to different interests, risks and commercial consequences'."

The FTT will have had in mind the following passage from Lord Upjohn's speech in *Brebner* (at 30):

> "My Lords, I would only conclude my speech by saying, when the question of carrying out a genuine commercial transaction, as this was, is reviewed, the fact that there are two ways of carrying it out - one by paying the maximum amount of tax, the other by paying no, or much less, tax - it would be quite wrong, as a necessary consequence, to draw the inference that, in adopting the latter course, one of the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out a commercial transaction except upon the footing of paying the smallest amount of tax that he can. The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners to decide upon a consideration of all the relevant evidence before them and the proper inferences to be drawn from that evidence."

85. Lord Upjohn's remarks must be apposite in the context of section 123(4) as well as section 28 of the 1960 Act. As, however, Mr Ewart pointed out, Lord Upjohn said that the existence of a less tax-advantageous alternative did not "as a necessary consequence" carry the inference that avoidance of tax was a

main object, not that the existence of such an alternative was necessarily irrelevant. Each case needs to be decided "upon a consideration of all the relevant evidence … and the proper inferences to be drawn from that evidence".

Did the FTT apply the correct legal test?

86. It will be apparent from the preceding paragraphs that we consider some of the FTT's observations on the law to be open to criticism. Does it follow that the FTT failed to apply the correct legal test when arriving at its decision? If it does, it is clearly open to us to revisit that decision.

87. As indicated above, Mr Ewart argued that the FTT's approach to the legal test could be seen to have involved errors of law and, hence, that we should set aside its decision. Mr Peacock, on the other hand, submitted that the FTT applied the correct legal test regardless of whether its observations on the law were all well-founded.

88. At this point, we unfortunately find that our views diverge. Judge Nowlan considers that errors of law led the FTT to apply the section 123(4) test in a wrong manner. Mr Justice Newey, in contrast, has not been persuaded that the FTT applied an incorrect legal test.

89. At paragraph 370 of the Decision, the FTT explained the issue before it in these terms:

> "The question we have to determine is whether the main object, or one of the main objects, of the letting of the Vessels on charter, or of a series of transactions of which the letting of the Vessels on charter was one, or of any of the transactions in such a series, was to obtain the 25 per cent writing-down allowances claimed by the Appellant in respect of its expenditure on the provision of the Vessels. If that is the case, the writing-down allowances cannot be claimed."

On its face, that passage reflects the law accurately.

90. In paragraph 388 of the Decision, the FTT said this:

> "We consider, therefore, that it is not fatal to a taxpayer's claim to capital allowances, where that claim is based on section 123(1) CAA 2001, that the taxpayer has taken steps which seek to secure or bolster his likelihood of obtaining those allowances. The question which has to be answered is whether a main object of the relevant transactions was the obtaining of those allowances, and this envisages that there may be a range of objectives motivating the transactions, and that they must be assessed in some sort of priority or hierarchy and then some basis applied to separate those which are of sufficient

significance to count as 'main' from those which are not. The issue is then which side of the line falls any objective of obtaining the allowances."

Taking issue to an extent with the second sentence of this paragraph, Mr Ewart made the point that it does not follow from the fact that object X is assessed to be more important than object Y that object Y cannot be a main object. That is true, but the FTT did not suggest otherwise.

91. Coming on to paragraphs 420 and 421 of the Decision, the FTT concluded that a main object of the relevant transactions was to secure a commercial benefit and went on:

> "The question then is whether it was also a main object of the transactions to obtain the writing-down allowances."

There is, as it seems to Mr Justice Newey, no indication there that the FTT was doing other than applying the correct legal test.

92. Having concluded in paragraph 426 of the Decision that "[t]he parties, in entering into the transactions for the letting of the vessels on charter, had as an objective that the capital allowances should be obtained", the FTT said in paragraph 427:

> "The objective of obtaining capital allowances was not a main objective of the transactions for the letting of the Vessels on charter. In our judgment the commercial objective we have identified above was paramount. Each transaction in the series of transactions relating to the letting of the Vessels on charter had a commercial purpose: it created an economic interest, transferred or shared a commercial risk, or was in pursuance of a genuine business endeavour. Overall, it is the case that the main objective of the transactions whereby, in September 2002, K-Euro took on the rights and obligations which would, on delivery of the Vessels, make it the disponent owner of the Vessels, was to achieve a commercial benefit distinct from, and not dependent upon, obtaining capital allowances. The capital allowances were a route to reduced cost of funds for the financing of transactions already decided upon. The parties knew this to be the case if the capital allowances proved to be available, and they wanted to obtain the benefit of such allowances, by ensuring that, in carrying out their commercial objectives, they would comply with the necessary conditions upon which the capital allowances were dependant. In terms of priority or hierarchy, that was subservient to, or of lesser importance than, achieving the commercial purposes of the relevant transactions."

In Mr Justice Newey's view, nothing in that paragraph shows the FTT to have been applying an erroneous legal test.

93. Although the FTT referred to the test that had to be met in *Melluish* as similar to that arising from section 123(4), it plainly asked itself whether "one of the main objects" was to obtain a writing-down allowance (as required by section 123(4)) rather than merely what "the sole or main benefit" that might have been expected to accrue from the transactions was (as the *Melluish* provision would have suggested). It is evident from the passages quoted above that the FTT recognised that a transaction could have more than one "main object" for section 123(4) purposes. Nor, in Mr Justice Newey's view, is it apparent that the FTT's (erroneous) comments on the role of section 123(4) (as to which, see paragraphs 77-79 above) affected the legal test it applied; as already mentioned, the passages from the Decision set out above are consistent with the correct test. Still less, as it seems to Mr Justice Newey, can there be any question of the brief reference to *Brebner* in paragraph 409 of the Decision disclosing that the FTT applied an incorrect legal test.

94. HMRC also complained that the FTT had focused on the objects of the series of transactions taken as a whole rather than considering each individual transaction. However, the FTT correctly identified the transactions which were alleged to fall foul of the "main object" test (see paragraph 392 of the Decision), and it also referred to them specifically in paragraph 420 of the Decision. It then (as Mr Justice Newey reads the Decision) considered whether it was a main object of those transactions to obtain writing-down allowances and eventually concluded (in paragraph 428) that "the obtaining of writing-down allowances was not the main object, or one of the main objects, of the letting of the vessels on charter or of any of the transactions in a series of transactions of which the letting of the vessels on charter was one". In the circumstances, it seems to Mr Justice Newey that the FTT addressed the relevant individual transactions as well as the wider picture.

The factual challenge

95. It is HMRC's case that, in deciding that the obtaining of capital allowances was not a main object, the FTT arrived at a conclusion that could not reasonably be entertained on the facts. According to HMRC, the only reasonable conclusion open to the FTT was that one of the main objects of inserting K-Euro into the lease structure was to obtain a writing-down allowance.

96. The essence of the FTT's views can be found in paragraphs 426 and 427 of the Decision. Paragraph 427 is set out above. Paragraph 426 is in these terms:

> "It is clear that K-Line was intent on securing finance lease funding of the Vessels. Such funding offered certain non-tax commercial benefits (such as full funding without any initial deposit) and a UK

finance lease prospectively offered the further commercial benefit of reduced cost of funding by reason of the capital allowances available to the finance lessor and shared by means of reduced rentals. The parties, in entering into the transactions for the letting of the Vessels on charter, had as an objective that the capital allowances should be obtained. K-Line sought advice so that it knew what the circumstances and conditions were that must obtain or be met in order that that objective could be achieved. We would characterise K-Line's attitude in seeking advice as being one of due diligence – the course of action was decided upon, but it needed to be as certain as it could before approaching prospective lessors that the arrangements it intended should be implemented would indeed secure the benefits to be derived from the capital allowances."

97. In summary, therefore, the FTT concluded that one of the parties' objectives when they entered into the relevant transactions was obtaining capital allowances, but that was not a main object. Commercial considerations were paramount.

98. Supporting the FTT's conclusions, Mr Peacock submitted that the lease structure adopted in 2001-2002 reflected commercial preferences of three entities or groups: the Snøhvit Sellers (including Statoil), K-Line and the Snøhvit Sponsors (amongst whom K-Line and Statoil were of course prominent). According to Mr Peacock, K-Line had a preference for lease finance as opposed to debt finance; Statoil and the other Snøhvit Sellers wanted the ships to be run safely and efficiently by a third party as owner/operator; Statoil was willing to participate in a joint venture with K-Line and other equity participants; the Snøhvit Sponsors wished to achieve an equity return while engaging a specialist in LNG to operate the vessels as "disponent owner"; Statoil was keen that the ship operator should be based in Europe; K-Line was concerned to develop its LNG business in the Atlantic Basin and globalise its business by setting up regional hubs; K-Line thought that it could achieve this through development of K-Euro; and K-Line wanted K-Euro to be a disponent owner so that it would have a close operational relationship with the Snøhvit Sellers. The lease structure allowed all these aims to be achieved.

99. For his part, Mr Ewart criticised the FTT's findings in six respects in particular. First, the FTT was wrong to reject HMRC's submission that the December 2001 documents represented the "real" commercial deal between the parties and that K-Euro was inserted into the structure only after K-Line had understood what needed to be done to allow capital allowances to be claimed. Secondly, the FTT was wrong to characterise K-Line's attitude in seeking advice as "one of due diligence". Thirdly, the FTT was wrong to take the view that K-Euro assumed the role of disponent owner. Fourthly, the FTT was wrong to accept evidence given by Mr Hiromichi Aoki of K-Line as to the aims of the K-Line group and its constituent companies in entering into

the relevant transactions. Fifthly, the FTT was wrong to conclude that K-Line's strategy of expanding its business in the Atlantic Basin and of developing regional business centres explained the decision to include K-Euro in the leasing structure. Sixthly, the FTT was wrong to consider that the 2006 reorganisation did not throw significant light on the parties' intentions in 2002.

100. In the course of submissions, there was extensive reference to the evidence before the FTT. It has to be remembered, however, that we are much less well-placed than the FTT was to assimilate and evaluate the totality of the evidence. The FTT saw the witnesses; we have not done so. We were taken to snippets from the transcripts of the oral evidence; the FTT heard all of it. The FTT had an exposure to the detailed documentary evidence and its interaction with that of the witnesses which we have not had.

101. In Mr Justice Newey's view, this is not a case in which it can be said that there was *no* evidence in support of the FTT's conclusions. Apart from anything else, Mr Aoki provided such evidence. Paragraphs 102 and 107 of his witness statement are particularly relevant. At paragraph 102, he said:

> "The form of the lease financing to be utilised for the Vessels continued to be discussed between K Line, the other Snøhvit Sponsors, and New Boston Partners between the date of New Boston Partners' mandate and the entry into the Preliminary Stage. During this period, consideration was given to a number of factors, including entry into a joint venture between a K Line entity and a third party ship management company (such as Denholms) so that this entity may perform the role of a full service shipping company. The attraction of setting up such a joint venture was that K Line thought that the entity would be in a position to provide full service shipping more quickly by way of a joint venture than through growing K Euro organically. However, this alternative was rejected, as it did not fit in with K Line's strategy for growth of the LNG and Bulk businesses. I had met with Denholms in February 2001 to discuss provision of the LNG crew for the vessels, and my recollection is that Denholms suggested the possibility of establishing a joint venture to act as a full service shipping company. I turned down this suggestion because it did not fit with K Line's plans for the development of K Euro, and my understanding of Statoil's requirements led me to believe that it would not have been acceptable to Statoil. I do not think that I even bothered to discuss with Statoil whether it would be an option for them. The suggestion was therefore rejected for purely commercial reasons."

In paragraph 107, Mr Aoki said:

> "Statoil required European operation of the Vessels, and K Euro was the logical place to locate this operation. The strengthening of K Euro's function helped achieve the K Line group's globalization strategy. The intermediary lessee role ensured that a K Line group company (rather than the consortium company) had a direct contractual relationship with Statoil, and we considered that this gave us commercial advantages. Also, the UK finance lease gave us a more favourable funding rate than other options. It is our duty to our shareholders to minimise costs and therefore maximise profits. However, our primary approach in structuring this transaction was to fulfil the real commercial needs of our counterparty and the K Line group's objectives. That these needs and objectives could be met at the same time as achieving lease financing was a positive result. K Line did not in any way alter its real commercial objectives or the way in which the requirements of the project were met in order to implement the lease finance arrangements."

102. Mr Aoki also gave relevant evidence orally. Among other things, he said that having K-Euro as a disponent owner helped with the K-Line group's strategy of developing its presence in the Atlantic Basin and that it "became natural" for K-Line to have its subsidiary playing a more substantial role in the chain. Asked about advice given by Mr McInerny of New Boston Partners (a leasing arranger), Mr Aoki said that the advice was "completely in accordance with our strategy" as regards activities in the Atlantic Basin.

103. There was undoubtedly evidence before the FTT supporting HMRC's case as well. We were taken to some of it. Correspondence with New Boston Partners provided Mr Ewart with a particularly rich seam. For example, on 1 August 2001 Mr Nagayama, the head of finance at K-Line, told New Boston Partners that "UK Lease" was an "interesting tool to achieve our finance target", and on 22 August New Boston Partners responded:

> "Thank you for the clarification of the ways K-Line is considering managing the new LNG vessels. It is useful that Statoil have made the request that the time zones are similar. This is certainly a good business reason to locate a new business in the UK or Europe and will be a helpful feature where the UK management trade is considered."

In November 2001 New Boston Partners said in an email:

> "However, we must remember that there are tax sensitivities here. To time charter we need both the operational and strategic management in the UK to establish a bona-fide shipping company but we must also meet the anti avoidance test relating to the bona-fide shipping exception – namely that it can be demonstrated that the sole or main benefit of the structure was not to allow the UK lessor to qualify for capital allowances. For the first point it would be easiest to have a

> third party existing bona-fide company to operate the vessels or act within a JV arrangement for yourselves. However, there is no doubt that K-Line could meet this test before delivery of the vessels on its own and the second point is likely to be more easily satisfied where K-Line manages and operates the vessel and I would anticipate the test will become progressively harder to meet with a JV or (even more so) a 100% third party."

Later that month, replying to a query relating to K-Euro, New Boston Partners wrote:

> "Question 4 is potentially sensitive from a tax perspective and we need to make the point that K-Line is considering this in the context of its overall operations and not just setting up a company for these 2 vessels – that is exactly what the anti avoidance legislation is trying to catch and we need to make sure all our correspondence throughout the deal process reflects the fact that if K-Euro becomes a bona fide company it is a strategic decision by the group taken at K-Line's board level."

104. Among the other materials on which HMRC relied was the MoU. As mentioned earlier, this stated:

> "If UK lease arrangements are not found to be economically and or legally viable by the Parties, the Parties shall arrange new financial scheme(s) and [K-Line] shall novate the [building contracts] and the [time charters] directly to the [special purpose companies that were to be established]."

HMRC argued before us that this provision supported their case that one of the main objects of inserting K-Euro into the structure was to obtain capital allowances, albeit that, according to Lloyds Leasing, the clause was not referred to in HMRC's written or oral submissions to the FTT.

105. Had the FTT decided in favour of HMRC rather than Lloyds Leasing, it is hard to see how that could have been considered unreasonable. It is far from clear to Mr Justice Newey that he would himself have arrived at the same conclusion as the FTT. That, however, is not the issue. For this Tribunal to be entitled to disturb the FTT's findings, it must conclude that they were unreasonable.

106. It is important to bear in mind in this context that the FTT, which had the advantage of seeing Mr Aoki give evidence, considered him a convincing witness and "well placed to speak of the aims of [the K-Line] group and of the reasons why group companies entered into the transactions with which we are concerned" (paragraph 400 of the Decision). It is also perhaps worth stressing that, to succeed in the appeal, HMRC must do more than show that

one of the parties' objects was to obtain a writing-down allowance. That much is uncontroversial, and the FTT expressly so found (see paragraph 426 of the Decision). HMRC has to establish, in effect, that no reasonable tribunal could have concluded that the admitted tax objective was not a *main* object.

107. Mr Ewart suggested that the FTT had paid too little attention to the intentions of Snøhvit Sponsors other than K-Line. However, the FTT recorded (in paragraph 231 of the Decision) that "[a]ll decisions as to the structuring of the lease financing, and the negotiation of the lease financing itself, were undertaken by K-Line". That view is borne out by evidence given by Mr Steinar Thomassen of Statoil, the other principal Snøhvit Sponsor. Mr Thomassen explained in his witness statement:

> "Statoil's concern was for the efficient, reliable and safe operation of the Vessels by a competent entity within the European time zone. How this was achieved contractually was not of particular interest to us. What I, and Statoil, cared about was the safe and efficient operation of the Vessels. I just wanted to ensure we achieved our commercial objectives, and that the K Line organisation would be responsible for the Vessels.
>
> Having entered into the leasing transaction, if we had been told, prior to delivery, that capital allowances would not be available, we would not have chosen to implement a different structure as between the Northern LNG companies, K Euro and the Charterers. The bareboat / time charter structure achieved all of our commercial objectives, and there would have been no reason to change it."

Asked in cross-examination about involvement in the bareboat charters between the Northern LNG companies and K-Euro, he said:

> "I don't recall we had any involvement in it except we knew that was going on."

108. In all the circumstances, it appears to Mr Justice Newey that this Tribunal is not entitled to interfere with the FTT's conclusion on Issue 4.

Judge Nowlan's views

109. As we have indicated, although we have agreed that some criticism is due in relation to the remarks of the FTT about the context in which to interpret section 123(4), and also about the FTT's acceptance that the test propounded in *Melluish* was similar to that in section 123(4), we have failed to agree whether that led the FTT to apply the section 123(4) test wrongly, as a material error of law. We have also failed to agree whether the FTT's evaluation of the facts relevant to the obtaining of the allowances undermined

the FTT's conclusion that the obtaining of the writing-down allowances was not one of the main objects of the two identified transactions.

110. Since Mr Justice Newey has the casting vote in this situation[1], the outcome of this appeal in relation to the fourth issue is that HMRC's appeal is dismissed. We will now summarise, however, the grounds on which Judge Nowlan would not have dismissed the appeal on the fourth issue. This would have been first on the ground that there was a material error of law in the way the crucial test was approached. In addition, if the FTT had evaluated the objective of obtaining the allowances correctly, they could not have arrived at any other conclusion than that the obtaining of the allowances was one of the main objects of the transactions. This would not have been on the basis that the obtaining of the allowances was the primary objective of the two identified transactions, which neither of us seeks to assert, but simply on the ground that, taking into consideration the four characteristics of the object of obtaining the allowances addressed below, the FTT should not have concluded that that object was anything but one major objective of the transactions.

111. Judge Nowlan accepts that in paragraph 370 of the Decision, quoted at paragraph 89 above, the FTT correctly quoted the main objects test of section 123(4). He also agrees that if one object is considered to have been more significant than another (the FTT having accepted that the obtaining of the allowances was an objective), the latter is the more likely of the two not to have been a major objective. Whilst that is clear, the remaining test, as the FTT indicated in paragraph 388, at the last sentence quoted in paragraph 90 above, is "then which side of the line falls any objective of obtaining the allowances".

112. Judge Nowlan considers that in the crucial paragraph 427 of the Decision, where the FTT concluded that the tax objective was not a major object, no explanation was given for this other than the feature that the commercial object was paramount. That is the explanation offered in the second and last sentences of paragraph 427, quoted at paragraph 92 above. The only other explanation given as to whether or not the object of obtaining the allowances might nevertheless have been a major object of the relevant transactions, was the FTT's description of the parties' approach to the obtaining of the allowances as one of due diligence, checking to ensure that the allowances available on the structure, adopted for commercial reasons, would indeed be available.

113. In considering whether the FTT made an error of law, and thereby failed to apply the key test correctly, Judge Nowlan considers that it is important to

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[1] See article 8 of the First-tier Tribunal and Upper Tribunal (Composition of Tribunal) Order 2008 (SI 2008/2835).

distinguish between two competing descriptions of the way in which the FTT addressed the crucial test.

114. The first possibility, that advanced by Mr Peacock, is that there was little significance to the fact that the FTT may have approached the legal test wrongly in its reference to the context in which to apply the test that we mentioned at paragraph 77 above, and by placing reliance on the test in *Melluish*. This was of little significance because when the FTT came to apply the test towards the end of the Decision, the very shortly stated test was first quoted accurately, and the FTT then accepted that, beyond quoting the test accurately, they still had to consider the additional question of whether the "non-primary object" (in their view) might still be a major object. Having thus reverted to approaching the test correctly, it is irrelevant that the only explanation offered for the ultimate conclusion appears to be based essentially on the point about the primacy of the commercial objects. That was the conclusion that they reached and they reached it in response to the correct test.

115. The second possibility is that there is more significance to the early references in the Decision to context and to *Melluish.* They are laying a deliberate trail that, far from being forgotten when the crucial test is quoted, continues to inform the FTT how in fact to apply the test, and as a consequence, the FTT applied the test wrongly.

116. It is worth going back to the passages of the Decision where the FTT was considering the significance of the *Melluish* test. While summarising Mr Peacock's contentions, the FTT referred to the *Melluish* test in the following way, which largely reflects the significance that they later attached to it:

> "377. The [*Melluish*] case shows that if the taxpayer claiming capital allowances is engaged in a commercial transaction where the allowances are nevertheless a significant factor in rendering that transaction commercially viable, obtaining the allowances is not a main purpose of the transaction."

117. The same approach was reflected in paragraphs 390 and 391 of the Decision. There the FTT said that:

> "390. We agree that in determining the objectives of the transactions, and ranking those objectives, a key factor – perhaps the key factor – is the commercial basis or justification for entering into those transactions, or, perhaps, the commercial purpose which is served for the parties in entering into those transactions. It will throw light on what the true objectives are and what their relative significance is if there is a range of objectives.

> 391. This was the approach of the court in the case of [*Melluish*], to which Mr. Peacock referred us. The case concerns a finance lessor's claim for 100 per cent first-year capital allowances in respect of its expenditure on the acquisition of two films which it acquired from its lessee in a sale and lease-back transaction. In order to claim successfully the allowances in the particular circumstances of the case the taxpayer finance lessor had to satisfy a 'main object' test similar to that faced by the Appellant in this case."

118. In Judge Nowlan's view, the reliance placed on the *Melluish* decision has confused this case, and the better view is that there was little relationship between the tests in that case and that in section 123(4). The feature that the test in *Melluish* referred to the "sole or main benefit" involves not just a minor difference in wording, but the obvious indication that if the obtaining of the allowances might be the sole object of the transaction, then there must have been something very artificial or illusory about the related acquisition of an item of plant or machinery. This is amply confirmed by the fact that the two sub-paragraphs of the relevant test in paragraph 3(1) of Schedule 8 to Finance Act 1971 other than the "sole or main [expected] benefit" sub-paragraph, referred to sales between connected persons and sales followed by leasebacks to the seller. In other words, the whole test was targeted at transactions that were first and foremost capital allowance schemes, and not commercial transactions where the obtaining of the allowances was nevertheless a main object.

119. No purposive interpretation of section 123(4) in this case will be any substitute for applying the wording in a straightforward manner, but if a purposive approach is needed, Judge Nowlan considers that an appropriate one is that the test is aimed at denying allowances in a situation where, without the insertion of a particular step, the conditions of section 123(1) to (3) would not be satisfied, whereupon if one main object of inserting the step has been to ensure satisfaction of the tests in the first three subsections, the writing-down allowances are denied. In that context the potential application of the test in this case cannot be described as remote, justifying an interpretation of subsection 123(4) to avoid "emasculating" the general benefit of all capital allowances. And the test in *Melluish* was targeted at something quite different.

120. This still leaves the question of which of the two competing analyses mentioned in paragraphs 114 and 115 above is to be preferred.

121. Judge Nowlan's answer to this question is that the summary in paragraph 115 above is the appropriate one. The FTT were clearly laying a trail in their early references to context and *Melluish*, all the attention was then given to commercial claims (not of itself at all objectionable of course), but there was no evaluation of the object, admitted to be an object, of obtaining the allowances. When the advice in relation to capital allowances was described

as due diligence advice, simply designed to ensure that allowances available on a structure selected for commercial reasons would indeed be available, Judge Nowlan considers this description to have been untenable. When the decision that the obtaining of the allowances was an object, but not a main object of the identified transactions, is then explained by reference to the primacy of the commercial objects, Judge Nowlan considers that it is principally by furthering and following the wrong trail laid in relation to context and *Melluish* that led the FTT to apply the test wrongly, as an error of law. When the question posed by section 123(4) all relates to the significance, as a main object or not, of the admitted object of obtaining the allowances, there must have been an error of law when the Decision failed to evaluate the significance of the tax advice, other than by describing it "in terms of priority or hierarchy, ... as subservient to, or of lesser importance than, achieving the commercial purposes of the relevant transactions".

122. While there are two separate questions raised by this fourth issue, namely whether there was an error of law in the decision, and whether the factual finding was one that the FTT should not have reached, Judge Nowlan considers that an evaluation of various considerations in relation to the obtaining of the capital allowances has a double relevance. It demonstrates the points that the FTT chose not to address, and thus fortifies the view given in paragraph 121 that there was indeed an error of law. As a distinct matter, it supports the view that the factual conclusion itself was wrong. This assertion involves no need to challenge the importance attached by the FTT to the commercial evidence. It is simply necessary to consider the following various features of the tax planning and the significance of the obtaining of the capital allowances, and then to answer the question of whether it was tenable that the object of obtaining those allowances was not a major object. This requires us to consider four different matters in relation to the obtaining of the capital allowances. They are:

- the evidence in relation to the early tax planning advice sought and given to K-Line, the timing issue of whether that preceded and required the tailoring of K-Euro's role to fit the tax structure, rather than that it followed the commercial role assigned to K-Euro, and the full extent of the tax planning advice;
- the financial significance of the obtaining of the allowances;
- the objects of the Northern LNG companies and their shareholders in relation to the obtaining of the capital allowances; and
- the bearing that discussions after 2002 and then the 2006 reorganisation may have on the initial objectives.

123. The first relevant feature is the very considerable attention given by the parties on and after April 2001 to the best financial structure to be adopted. As the FTT made clear in summarising the facts, in April 2001, and clearly before any structure had been selected, K-Line commenced research into finance and leasing structures in five different countries (the UK, US, Spain,

5 France and Japan); it sought advice from seven banks or financial advisers, and the broad consensus of that advice was that UK leasing provided the greatest benefit. By August 1 2001, Mr Nagayama, the head of finance at K-Line was commenting to New Boston Partners (the chosen primary financial adviser):

> "Thanks for your information of UK Lease. As we consider UK Lease is interesting tool to achieve our finance target, we would like to move to next step of feasibility study whether it is applicable to the LNG vessel in use for the Time Charter Service as below."

124. Another reference, again from Mr Nagayama updates New Boston Partners on 27 September 2001 to the effect that:

> "We are still considering K-Euro would be a first candidate of UK lessee because we do not have other suitable entities in UK. So we would like to introduce staff of this company to you during my stay in London in order for you to examine whether K-Euro is qualified as bona fide shipping company. In the meanwhile, we are now studying to carry out ship management of these LNG Carriers together with Denholm. As I asked you in the meeting at our office on 6th Sept, we would like to also study the way to establish bona fide shipping company in assistance of Denholm."

125. In a fairly graphic way, New Boston Partners were again commending the UK tax benefits of the eventual structure adopted to Mr Nagayama and to numerous other addresses in October 2001 in the following terms:

> "The beauty of this structure from a UK perspective is that the taxable time charter income is offset by the costs of operation and the bareboat charter income paid to the offshore company. This means that the UK companies' net taxable profits are (i) limited to that of an operator rather than owner and (ii) are predictable and calculable from market rates and practice. This structure will apply equally to container vessels and bulk ships (or any other form of ocean going vessel) and so the main benefit of UK Tonnage Tax – limiting the potentially large profits in the UK - is already available. It is true that the Tonnage Tax payable in the UK is likely to be less than tax on the retained operator profit, but there are a series of other restrictions and requirements of Tonnage Tax that also have a cost, for example the crew training requirements and the detailed disclosure requirements. You should also consider that larger container ships have a cost substantially in excess of GBP 40 million (we have been looking at large container vessels in excess of USD 90 million each recently) and so may not be appropriate for Tonnage Tax anyway if the market continues to look to larger vessels.

The fact that 2 LNG vessels will generate a substantial benefit of about $30 million (for 20 years) to $40 million (for a 30-year lease) is very material given that the structure already ensures that the profits retained within the UK are appropriate for an operator, with the owners profitability being retained offshore."

126. The various competing candidates for the role of the UK company were certainly still being considered in November 2001, as the second extract from a New Boston Partners email, that we quoted in paragraph 103 above, makes clear. The significance of that paragraph is that the initial tax structuring advice had been given and accepted, namely that a UK company would have to take a bareboat charter of the vessels and then time-charter them to the Snøhvit Sellers, and the tax advice was then concentrating on the best candidate to satisfy both the tests in section 123(1) to (3) and 123(4).

127. A further email from New Boston Partners, also in November 2001, was commenting on various questions that Statoil had put to K-Line, question 4 asking about the status of K-Euro. The response from New Boston Partners, being the first quotation recorded in paragraph 103 above, is significant not because it should be read to contain a suggestion that efforts should be made to misrepresent reality, but that again it made clear that K-Euro had not been chosen as the vehicle to perform the role of the required UK company in the structure, albeit that by this stage all the planning tax advice had been given, and seemingly K-Line was attracted to the benefits of the structure being promoted.

128. When the MoU was entered into on 19 December 2001, the only parties at that stage were K-Line and Statoil, K-Line committing to time charter the vessels to Statoil on behalf of the Snøhvit Sponsors. The MoU did, however, clearly evidence the intention that UK lease financing would be adopted and it recorded the parties' intention that the building contracts would be novated to a UK lessor, leases of the two vessels would be granted to "special purpose companies", and those SPCs would grant bareboat charters "to a company or companies incorporated and carrying on business as ship operators in the UK .. to whom the time charters would be novated". The MoU then noted that "if UK lease arrangements are not found to be economically and or legally viable by the parties, the parties shall arrange new financial scheme(s) and [K-Line] shall novate the [building contracts] and the [time charters] directly to the SPCs".

129. The significance of that last quotation from the MoU, after all the first structure document actually entered into by the parties, was not only that the MoU was indicating the likely introduction of the transactions presently in contention, but that it was suggested that if the capital allowances were eventually considered not to be available, the likelihood is that the SPCs, and not the envisaged UK company, would take the novation of the time charters. Notwithstanding the obvious temptation to refer to commercial

considerations, there was no indication that commercial considerations would still require the interposition of K-Euro, albeit that the UK finance lessor might be omitted at the head of the chain of leases. The role to be performed by K-Euro appears to have been ignored in the scenario that there might be no attempt to claim UK allowances.

130. Judge Nowlan considers that a fair summary of the few extracts that we have quoted above from the extensive email correspondence in the early period and from the MoU is that tax and financial advice were being sought for structural, and not due diligence, reasons; great attention was being paid to the UK tax sensitivities and to selecting the right vehicle that would perform the role of the "UK lessee" and disponent owner, and that to describe any of this financial and planning advice as mere due diligence was simply untenable. There is also no indication in any of this correspondence that tax advice was being sought to ensure that the tax implications would be acceptable for a structure dictated by, and preferred for, commercial reasons. The tax and financial structuring appears to have been the dominant subject at least of all the relevant email traffic in this early period.

131. The second aspect that Judge Nowlan considers ought to have been taken into consideration, in evaluating whether the objective of obtaining capital allowances was a major object of the relevant transactions or not, was the financial significance of obtaining those allowances.

132. Our understanding is that the net present value of the savings to be derived by the non-Lloyds Leasing parties to the transactions in terms of the rental savings derived from the benefit of UK writing-down allowances was approximately equal to 10% of the contract price of the vessels. This calculation varied with the length of term of the lease, the rate of UK corporation tax, and the manner in which rentals were funded or secured. The net present value figure of roughly £20 million was based on a 30-year lease, and naturally pre-supposed that the lease would run for its full term.

133. It seems difficult to describe that level of saving as anything but significant and "major", particularly after Mr Nagayama had described "the UK lease [as an] interesting tool to achieve our finance target".

134. It is also worth observing that not only was the financial consequence of obtaining the allowances most significant, but the consequence of adopting the chosen structure but then failing to meet all the tests in section 123 would be that severe rental adjustments would be made under the terms of the Lloyds Leasing finance lease. Lloyds Leasing would pass on to the Northern LNG companies the adverse tax consequence of having been recovering expenditure for which no allowance of any sort would have been obtained, in the form of taxable rentals, and would thereby preserve their originally projected return. Whilst this feature would have certainly justified due

diligence advice, it was also an additional factor that made it essential to obtain the writing-down allowances.

135. The third feature that Judge Nowlan considers that the FTT should have considered in evaluating the significance of the tax objectives of the parties is that some reference should have been made to the fact that the non-Lloyds Leasing parties that it was hoped would actually obtain the benefit of the writing-down allowances (through reduced rentals) were the Northern LNG companies and their shareholders, rather than K-Euro at all. The FTT essentially gave consideration only to the objects of K-Euro, and indirectly to the commercial preferences of K-Line. While it might be realistic to conclude that the Cayman Isles SPCs themselves would have given little consideration to any objectives, it is important to remember that 51% of the shares of Northern LNG I were owned by three companies other than K-Line, 64% of the shares of Northern LNG II were owned by those three companies, and the balance of the shares in the two companies were owned by K-Line and not K-Euro. Since K-Line always intended to attract other companies into the equity owning structure, and the obtaining of the capital allowances significantly enhanced the investment returns that those companies would expect to make and thus the whole appeal of participating in the ownership structure, the FTT should have considered this aspect of K-Line's objectives. It is also difficult to believe that those other equity participants (particularly the two major Japanese companies with no other role or interest in the transactions) could have ignored the rewards and risks of the key planning decisions, and participated without giving any independent thought to these aspects.

136. Insofar as there were any commercial implications to the Northern LNG companies in shedding any risks to K-Euro by granting K-Euro the bareboat charters, these implications seemed to be secondary to the significance of the obtaining of the capital allowances, but at the very least not to render the obtaining of those allowances merely an incidental object. The letter that we quote in paragraphs 138 and 139 below suggests that the risks were passed to K-Euro in order to sustain the tax structure, rather than to further any commercial object, and in any event as soon as the manning costs increased, it became clear that in reality the Northern LNG companies had not shed the risks since they had effectively to acquire K-Euro itself, and re-acquire any risks that might have been passed to K-Euro.

137. The fourth and final factor to which Judge Nowlan considers that the FTT should have given attention in evaluating the objectives of the transactions was the significance of the approach of the parties, as crewing costs for the vessels increased and K-Euro appeared to be destined to make losses rather than the advised 10% margin over its manning and maintenance costs.

138. The FTT dismissed a letter of 10 January 2003 to the Snøhvit Sponsors from Mr Yasui, described as the General Manager of the LNG group of K-Line, because nobody replied to it. It is nevertheless significant that the letter was

describing matters from the perspective of K-Line and two extracts are worth quoting as follows:

The first was as follows:

> **"Present Structure**
>
> Sponsors have adopted UK tax lease for financing the Vessels. As the consequence of adopting UK tax lease, K-Line's affiliated company in UK, K-Euro is involved in the structure as UK bona fide shipping company and will act as bareboat charterer in the project financing.
>
> Shipowning JVs are now bareboat owners and Sponsors become remote from the risks and cost control.
>
> On the other hand, K-Euro, which is not considered as the participants in the structure, is forced to bear … some additional risks and benefit as mentioned below."

139. A yet more surprising paragraph is the following:

> "(3) Additional Cost to establish 'UK bona fide company'
>
> In accordance with the K-Euro Business Plan, K-Euro strengthened its organisation to be regarded as a UK bona fide company which was not considered in Original Understanding.
>
> (4) Retention of 10% of OPEX
>
> K-Euro is required to retain 10% of OPEX as the profit by the Bareboat Charter in order to be considered as UK bona fide company under the UK tax lease scheme."

140. This letter seems to be suggesting, almost exactly as HMRC contended in its most extreme contention against Lloyds Leasing, that K-Euro's role was driven by the need and the desire to fulfil a tax role and that the company's business was built up to support that objective. At the very least it is suggesting that at least one of the reasons for inserting K-Euro into the structure was to support the tax objectives.

141. The related terms of the 2006 reorganisation were similarly significant. The FTT agreed that a later transaction might throw light on the relevant objectives back in 2002, principally when the later transaction was contemplated in 2002. It is clear that the 2006 reorganisation was not so contemplated. It is still however highly significant that the 2006 reorganisation involved the abandonment of every feature of the 2002 structure of any commercial significance, but it carefully preserved the

technical ability to claim the allowances. K-Euro, through its alphabet share rights, ceased to be a K-Line company, its A shares being under common control with Northern LNG I, and its B shares with Northern LNG II. All the "other activities" inserted into K-Euro were removed, and because K-Line and not the Northern LNG companies were obviously meant to be responsible for maintenance and manning, those functions, while alone left in K-Euro, were sub-contracted to a different K-Line UK company. The feature, therefore, that every commercial objective was then abandoned, and the tax objective hopefully preserved in the changed conditions appears to throw some light, in retrospect, on the significance of the tax objective, if not indeed on the whole issue of primacy.

142. It is immaterial, in the light of Mr Justice Newey's casting vote, for Judge Nowlan to indicate whether his decision would have been to remit the matter back to the FTT, or simply allow HMRC's appeal on the fourth issue on the ground that the FTT failed to apply the section 123(4) test correctly and failed to evaluate the various parties' tax objectives fully, and that the above considerations provided sufficient evidence that the tax objectives must have been one of the major objects of the bareboat charter and novation of the time charters to K-Euro. In the light of our failure to reach common conclusions and of the manner in which the various witnesses all professed to know nothing about the taxation advice and since some of the documents to which we have referred may not have been put to the witnesses, Judge Nowlan's preferred course would have been to remit the matter back to the FTT for further consideration of the points addressed in his dissenting opinion. Judge Nowlan's further view is that had Mr Justice Newey reached different conclusions himself, and had those extended to his being prepared to allow HMRC's appeal on the fourth issue, rather than merely to remit the matter back to the FTT, Judge Nowlan would have had no hesitation in then agreeing that there were ample grounds on which to allow HMRC's appeal on this fourth issue.

Conclusion

143. We both consider that the Tribunal was entitled to arrive at the conclusions it did on Issues 1, 2 and 3.

144. We have unfortunately failed to reach agreement on Issue 4. In the circumstances, the appeal on that ground is unsuccessful as well.

145. The overall result is that the appeal is dismissed.

Mr Justice Newey **Judge Howard Nowlan**

5 **RELEASE DATE: 14 August 2013**

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