PRESS SUMMARY

11 May 2011

Commissioners for Her Majesty's Revenue and Customs (Appellant) v Tower MCashback LLP 1 and another (Respondents) [2011] UKSC 19

JUSTICES: Lord Hope (Deputy President), Lord Rodger, Lord Walker, Lord Collins, Lord Kerr, Lord Clarke, Lord Dyson

BACKGROUND TO THE APPEAL

This appeal raises two issues of tax law. The first ("the procedural issue"), of general importance to the self-assessment regime, concerns the scope of arguments which may be advanced by HMRC in a taxpayer's appeal against a closure notice which the HMRC issues to conclude its enquiry into a tax return. The second issue ("the expenditure issue") concerns the proper approach to determining whether expenditure has been "incurred" for the purposes of the Capital Allowances Act 2001.

The case concerns the tax consequences of the scheme used by MCashback Limited ("MCashback") to raise finance to enable it to "roll-out" M Rewards, a software package which it had developed and which enabled manufacturers to promote products to customers by offering free mobile phone airtime. On the advice of Tower Group plc (Tower), it was decided to raise funds by selling rights to the software, via software licence agreements (SLAs), to four Limited Liability Partnerships to be set up as part of the financing scheme. Tower personnel were founder members of the LLPs and negotiated the SLAs with MCashback. The SLAs provided for each LLP to receive a proportion of the clearing fees which manufacturers would pay in respect of each transaction via the M Rewards system. For the purposes of this litigation, the situation of Tower MCashback 2 LLP (LLP2) has been taken as representative of the other LLPs. LLP 2 entered an SLA with MCashback, under which it was to pay £27.5m for a licence of part of the M Rewards system. LLP2 was entitled to 2.5% of the gross clearance fees received from exploitation of M Rewards. LLP2 obtained the funds required to pay the consideration under the SLA (and the associated professional fees) from investors, who became investor members of LLP2. They contributed 25% from their own funds and obtained the remaining 75% from bank borrowing, on uncommercial terms. Janus Holdings Ltd (Janus) lent the required sum to a special purpose vehicle set up by Tower, which made interest-free, non-recourse loans to the investor members. MCashback was obliged to deposit approximately 82% of the consideration due to it in terms of the SLA as indirect security for the investor members' borrowing from Janus. These sums were placed on security deposit with R&D Investments Ltd (R&D), which R&D in turn deposited with Janus as security for Janus's loan to the SPV.

LLP2 claimed £27.5m first year capital allowances for the 2004/05 tax year, the amount of consideration set out in the SLA. Because of the way LLPs are taxed, the investor members would take the benefit of these allowances if the claim is successful. One of the conditions for entitlement to capital allowances is that a person "incurs qualifying expenditure": section 11 Capital Allowances Act 2001. Expenditure is qualifying expenditure if, amongst other things, it is capital expenditure on the provision of plant or machinery, which includes software or rights to software. On 30 June 2005 HMRC issued a notice of enquiry into LLP 2's partnership return. Attention initially focused on section 45(4) CAA 2001, which withholds first year allowances for expenditure on software rights in certain circumstances. After a lengthy period of enquiry, during which correspondence was exchanged about the application of section 45(4), HMRC issued closure notices (under s28B Taxes Management Act 1970) which stated that, "as previously indicated … the claim for relief under section 45 CAA

2001 is excessive" and amended the partnership return so that the capital allowances claimed, and allowable loss, were "nil".

The LLPs appealed against the closure notices. Before the Special Commissioner, HMRC abandoned the argument that the claims were disallowed by section 45(4) CAA and sought instead to argue that the full extent of the consideration under the SLAs was not expenditure incurred on software. The Special Commissioner decided the procedural point in favour of the HMRC, allowing them to advance this argument, and, on the expenditure issue, disallowed 75% of LLP2's claims. On appeal, the High Court allowed the LLPs' appeals on the procedural issue. It would also have allowed the LLPs' appeals on the expenditure issue, had the point arisen for decision. The Court of Appeal, by majority, reversed the High Court on the procedural issue (Arden LJ dissenting), but agreed with the High Court on the expenditure issue. HMRC appeals against the determination of the expenditure issue and the LLPs cross-appeal against the determination of the procedural issue.

JUDGMENT

The Supreme Court unanimously allows the HMRC's appeal and dismisses the LLPs' cross-appeal. Lord Walker issues the leading judgment and Lord Hope a short, concurring judgment. The other members of the Court agree with both. It therefore holds that the HMRC could advance alternative arguments on the expenditure issue, and that all of the consideration provided for in the SLA was not expenditure incurred on the provision of software. The Court directs that the closure notices be amended to allow only 25% of the first year allowances claimed.

REASONS FOR THE JUDGMENT

Procedural issue

The Special Commissioners are free to entertain legal arguments which played no part in reaching the conclusions set out in the closure notice. The scope and subject matter of the appeal will, however, be defined by the conclusions stated in the closure notice and any amendments made to the return. The Court emphasises that this is not to be taken as encouragement to HMRC to draft every closure notice in wide and uninformative terms. There is, however, a public interest in taxpayers paying the correct amount of tax and it is one of the duties of the Commissioners to have regard to that public interest. Any potential unfairness to the taxpayer can be avoided by proper exercise of case management powers during the appeal: **[15] - [18]; [83] – [85]**.

Expenditure issue

The court considers two previous decisions of the House of Lords: *Ensign Tankers (Leasing) Ltd v Stokes* [1992] 1 AC 655 and *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51. Both remain good law: **[72]** It is not enough for HMRC, in attacking a scheme of this sort, simply to point to money going round in a circle: **[77]** Nor, however, is it the law – as the judge had held – that unless one finds the transaction in this case to be a sham, the only possible conclusion is that the whole of the consideration in the SLA was expenditure incurred on the provision of software. In the context of a complex pre-ordained transaction, the court's task is to test the facts, realistically viewed, against the statutory test, purposively construed: **[67]** Entitlement to capital allowances requires there to have been real expenditure for the real purpose of acquiring plant or machinery for use in a trade: **[80]**. Concerns about the valuation of what is being acquired and the commercial soundness of the transactions are relevant. The fact that rights in the software had been transferred by MCashback to LLP2 demonstrated the reality of some expenditure on acquiring those rights, but did not conclusively show that the whole of consideration in the SLA was expenditure for that purpose. The Special Commissioner found that the market value of the software was "very materially below" £27.5m. He had also held that there was little chance that the members' loan would be repaid in full within ten years – as much as 60% might be unpaid, and waived, at the end of that period. These findings justified the conclusion that the money which the investor members borrowed was not used, in any meaningful sense, as expenditure in the acquisition of software rights. Instead, it went in a loop back to the lender in order to enable the LLPs to indulge in a tax avoidance scheme: **[75]**

NOTE

This summary is provided to assist in understanding the Court's decision. It does not form part of the reasons for that decision. The full opinion of the Court is the only authoritative document. Judgments are public documents and are available at:
www.supremecourt.gov.uk/decided-cases/index.html