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HMRC v Lloyds TSB Equipment Leasing (No.1) Ltd: when is saving tax the "sole or main object"?

Introduction

The important decision of the Upper Tribunal (Tax and Chancery) (UT) in *HMRC v Lloyds TSB Equipment Leasing (No.1) Ltd* (*Lloyds TSB Leasing*)[1] concerned the finance leasing of two ships, the UK capital allowances rules in respect of "overseas leasing", and above all the scope of

[1] *HMRC v Lloyds TSB Equipment Leasing (No.1) Ltd* [2013] UKUT 368 (TCC) (Upper Tribunal (Tax and Chancery)).

anti-avoidance rules of a kind which are widespread in UK tax legislation: and which deny a tax relief where "*the sole or main object*" of a transaction was the obtaining of a tax benefit. Despite the effective repeal of the specific legislative provisions examined in the case, the decision therefore has continued relevance. The decision has been appealed to the Court of Appeal.

The facts

In January 2001, a group of non-UK-resident energy companies, led by Statoil ASA (the Consortium), initiated a tender process for the acquisition and operation of two ships to transport liquefied natural gas from the Barents Sea, with the Consortium being the end-user. The tender process was won by a major Japanese shipping company, Kawasaki Kisen Kaisha Limited (K-Line) which entered into construction contracts with Japanese shipbuilders, and time charterparties of the two ships with Statoil ASA on behalf of the Consortium. In December 2001, Statoil ASA and K-Line entered into a Memorandum of Understanding confirming that UK finance leasing would be used to finance the ships because of certain advantages identified during the tender process, notably the availability of UK tax depreciation allowances (capital allowances) in respect of expenditure on the ships.

The Consortium then approached a leasing subsidiary of the Lloyds TSB Group, Lloyds TSB Equipment Leasing (No.1) Ltd (Lloyds Leasing) in September 2002. Lloyds Leasing agreed to acquire the two ships for over £198 million and the construction contracts were novated in its favour.

Lloyds Leasing subsequently granted two long finance leases to two Cayman Island-resident companies (the Northern LNG companies), the majority shareholders of which were K-Line and Statoil ASA. The Northern LNG companies thereby assumed the financial risk of owning and operating the vessels, although Lloyds Leasing retained the legal title to them and the right to any capital allowances under the then UK tax rules. The Northern LNG companies granted "bareboat" charters to K-Euro, a UK-resident subsidiary of K-Line. K-Line then novated their rights and obligations under the time charterparties to K-Euro. The time charterparties were, somewhat unusually, long-term bespoke contracts, reflecting the specialised nature of the carriers.

In 2006, during the construction of the carriers, K-Euro was re-organised. In particular, because of unexpected increased costs of manning vessels, it was forced to confine its activities to bareboat—chartering and operating the two carriers, with manning and maintenance obligations being contracted out by it for a fee to another K-Line company. In April 2009, HMRC rejected a claim for capital allowances by Lloyds Leasing in respect of the two ships. Lloyds Leasing successfully appealed HMRC's decision to the First-tier Tribunal (FTT).[2] HMRC then appealed to the UT which dismissed the appeal, agreeing with the FTT on three out of the four issues in the case but not reaching unanimity on the fourth issue. Hence, the senior judge, Newey J, exercised a casting vote on that issue, in favour of the taxpayer.

[2] *HMRC v Lloyds TSB Equipment Leasing (No.1) Ltd* [2012] UKFTT 47 (TC) (First-tier Tribunal (Tax Chamber)).

Legislative background

This case revolved around a series of rules first enacted in the early 1980s restricting (and in some cases denying) plant and machinery capital allowances to lessors of equipment where the end-user of the equipment is not within the UK tax charge.[3] These restrictions on so-called "outbound leasing" reflected the UK Treasury's unwillingness to permit UK capital allowances to be used to subsidise equipment financing which did not generate revenue for the UK fisc from the equipment users. They do not apply to leases entered into on or after April 1, 2006, the date on which extensive changes regarding the capital allowances regime and finance leasing came into force. The general restrictions on allowances on "outbound leasing" were contained in sections 109 and 110 of the Capital Allowances Act 2001 (CAA). However the focus in the case was the scope of the carve-out from the restrictions imposed by those rules for certain ship-chartering activities contained in section 123 CAA (section 123). The effect of section 123 was that allowances may be permitted even where (as here) the person chartering the ship was outside the UK tax charge. Section 123 was summarised by Newey J in the UT as effectively ousting the normal rules 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."[4]

The question was whether the protection of section 123 applied where the two bulk carriers were leased indirectly by a UK finance lessor, via the UK subsidiary of a Japanese shipping company, to a group of non-UK companies, at a time when that UK subsidiary was only operating those bulk carriers and had subcontracted its management activity to another company.

The decision

As noted earlier, there were four aspects to the decision of the UT.

[3] The "outbound leasing" restrictions were adapted and re-enacted several times, most recently in the Capital Allowances Act 2001 (CAA) ss.109 and 110. They were also the subject of earlier litigation in *BMBF (No.24) Ltd v HMRC* [2003] EWCA Civ 1560; [2004] STC 97. Arguments had been raised about whether these restrictions were compatible with EU law on the freedom to provide services, especially following a decision of the European Court of Justice in *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna* (C-294/97) [1999] ECR I-7447 in the late 1990s. HMRC part-conceded these arguments in Brief 40/07 (May 2007). It is perhaps surprising that such arguments were not raised in this case because Statoil ASA is resident in a country, Norway, which belongs to the European Economic Area.
[4] *Lloyds TSB Leasing*, above fn.1, [2013] UKUT 368 (TCC) at [8].

(i) Defraying expenses

The first question considered by the UT was a very narrow point on the detailed wording of section 123(1) which required the taxpayers to establish that K-Euro was responsible for defraying all, or "substantially all", expenses in connection with the bulk carriers under the time charter throughout the charter period, other than those which were voyage specific. If not, the section 123 carve-out from the "outbound leasing" rules would not protect the capital allowances claim. However, after a detailed review of the terms of the charter and its hire computation provisions, the UT, like the FTT, found in the taxpayer's favour. This part of the decision has little or no wider relevance and is therefore not considered further.

(ii) The trading question

The second issue was whether K-Euro was time-chartering the bulk carriers to the Consortium in the course of a trade[5] consisting of or including operating ships, even though the intention to generate capital allowances for the UK finance lessor was an important factor in setting up the chartering structure and determining within it the role of K-Euro, not just as a manager but as an owner of the ships. The UT was prepared to accept the FTT's ruling that K-Euro was acting in the course of a trade. Had K-Euro not been carrying on such a trade, capital allowances in respect of the bulk carriers would not have been available.

In particular, the UT was unwilling to deny trading status to K-Euro on the basis of certain older court decisions.[6] These cases treated transactions as not amounting to trading where they were excessively distorted or "denatured" by tax planning.[7] Generally, since the early 1990s, the courts have been hesitant about extending this line of cases.[8] The decision of the UT is consistent with this trend. In particular, trading status is not to be denied merely because a transaction was entered into with the intention of securing a tax benefit, unless this deprives the transaction of commerciality. That was not so here. The intention of K-Euro to make a profit from its chartering activities was an indication of trading even though unexpected increases in manning costs led to its original (ambitious) bulk carrier business plans being scaled down and its role limited, from 2006, to time-chartering two (very valuable) bulk carriers. The UT also noted findings of fact by the FTT about the commercial risks borne by K-Euro. These genuine risks again supported the conclusion that K-Euro was conducting a ship-operating trade, even though the risks changed, and were more limited, following the 2006 restructuring.

(iii) The scope of section 123(4) CAA

The third issue concerned the scope of section 123(4) CAA (section 123(4)) (which removed the protection of section 123 where a main object of a transaction is tax avoidance) and its relationship with sections 109 and 110 CAA. The taxpayers raised a technical argument based on the fact that section 123(4) CAA referred to section 109 (which restricted allowances to 10

[5] As required by CAA s.123(1).
[6] Such as *Lupton (Inspector of Taxes) v FA & AB* (*Lupton*) (1971) 47 TC 580 (HL).
[7] For example, in *Lupton*, above fn.6, (1971) 47 TC 580, an artificial dividend-stripping transaction took place where the taxpayer claimed a tax deduction without incurring an economic loss.
[8] See *New Angel Court v Adam (Inspector of Taxes)* [2004] EWCA Civ 242; [2004] STC 779.

per cent of expenditure rather than the normal 25 per cent) rather than section 110 (which reduced allowances to zero). The argument of the taxpayer was that, because in this case the taxpayers would (in the absence of the section 123 protection) be subject to section 110, section 123(4) could not remove the protection because it referred only to section 109. Therefore, the argument continued, section 123(4) did not apply. Both tribunals rejected this argument. It was based largely on the way in which the "outbound leasing" rules had been redrafted under the Tax Law Rewrite Project, which led to the CAA replacing the Capital Allowances Act 1990. The change in wording between the two Acts was semantic and there was no obvious legislative intention to alter the policy underlying the "outbound leasing" restrictions, at the time of the Rewrite.

(iv) Did section 123(4) CAA apply on the facts?

The fourth and most significant part of the UT's decision was its divided opinion on whether, on the facts, a "main object, or one of the main objects" of the ship leasing, or of a "series of transactions" of which it formed part, was the obtaining of unrestricted capital allowances. If it was, then, under section 123(4), such allowances (under the ship-chartering exception to the "outbound leasing" rules) would be denied. Here, Judge Nowlan disagreed with the FTT, and ruled that there was a "main object", not just an insignificant object, of obtaining unrestricted allowances, not least because K-Euro could have fulfilled its allotted role by managing the ships, rather than entering into the bareboat and time charters. It entered into the charters primarily to meet the technical conditions for unrestricted capital allowances to be obtained. Newey J was less sure and gave the FTT, as the fact-finding tribunal, the benefit of the doubt. Hence, given his casting vote, the taxpayer prevailed on this key point. However, it was clear that Newey J also had major misgivings about the FTT's decision on this point.

The UT, correctly in the opinion of the writer, ruled that when interpreting section 123(4) CAA, the previous High Court decision of *Barclays Mercantile Finance v Melluish* (*Melluish*)[9] was not a reliable guide, despite contrary assertions by the taxpayer. That earlier decision focused instead on a narrower anti-avoidance rule which applied where "*the sole or main object*" of a transaction was the obtaining of a tax benefit. This test set a higher bar for HMRC to meet than the test of whether *at least one* of the transaction's "*main objects*" was obtaining a tax benefit. Hence it shed little or no light on how to read section 123(4), which clearly envisaged that a "main object" of avoiding tax could co-exist with one or more non-tax-motivated "main objects". Newey J considered that the FTT had correctly taken into account the difference between the "sole or main object" test and section 123(4) and hence had applied the correct legal test when it concluded that obtaining allowances was an object, but not a "main object", of the transaction, where commercial objectives were paramount. There was also evidence, in his view, to support the FTT's conclusion.

Judge Nowlan however thought that, despite appearances, the FTT had continued to be influenced, erroneously, by the *Melluish*[10] decision on the "sole or main object" test. In his view, the only sensible conclusion was that obtaining unrestricted capital allowances was a "main

[9] *Barclays Mercantile Finance v Melluish (Inspector of Taxes)* [1990] STC 314 (Ch D).
[10] *Melluish*, fn.9 above, [1990] STC 314.

object" of the transaction. Hence such allowances were unavailable, even if other non-tax-motivated "main objects" existed concurrently.

The UT was unwilling to accept that section 123(4) should be read restrictively simply because the remainder of section 123 provided an exception from the "outbound leasing" restrictions. HMRC's interpretation of section 123(4) was not to be rejected simply to avoid "emasculating" the ship chartering carve-out in section 123.

The UT (especially Judge Nowlan) was also dismissive of statements by the FTT that the obtaining of detailed legal and tax advice in respect of the availability of capital allowances was merely "due diligence", and hence obtaining those allowances was not a "main object". While the term "due diligence" perhaps trivialises a key aspect of the transaction structuring, the FTT comment was in fact made in a wider context: namely, K-Euro and its counterparties were found, on the facts, to have clear commercial motives and the availability of capital allowances was an important but secondary issue in financing efficiently the expansion of K-Euro's Atlantic bulk carrier business. This point leads on to the wider implications of the decision.

Generally, in any major commercial transaction involving significant financing, well-advised parties will always pay close attention to the cost of funds and the impact of tax rules on those costs. To take a simple example, a UK takeover bid will typically be funded mainly with interest-bearing debt, not equity, because interest on the debt (unlike dividends) is generally tax-deductible and those deductions can then be offset against UK-taxable profits of the target using "group relief". Funding such deals mainly with debt, and in a manner enabling "group relief" to be claimed, therefore significantly reduces after-tax deal costs, and this will always heavily influence a sophisticated, well-advised taxpayer. Lord Upjohn recognised this commercial reality in his well-known statement in *IRC v Brebner*[11] where, in considering language very similar to section 123(4), he said:

> "I would only conclude my judgment by saying, when the question of carrying out a genuine commercial transaction, as this was, is considered, 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 … 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 involved."

The UT cited Lord Upjohn's statement with approval but some of the UT's comments in *Lloyds TSB Leasing*[12] seem not to take fully into account the commercial reality of which Lord Upjohn was very aware: namely that the tax system offers taxpayers structural choices with different tax consequences or indeed that, in many commercial transactions, tax planning is inevitable to avoid "elephant traps" in the legislation which, if ignored, could trigger largely unintended tax charges which would undermine such a transaction.

The facts of *Lloyds TSB Leasing*[13] itself were clearly on the borderline, evidenced by the disagreement in the UT. However, given the UT's thoughts on section 123(4), only a very small

[11] *IRC v Brebner* (1967) 43 TC 705 (HL).
[12] *Lloyds TSB Leasing*, above fn.1, [2013] UKUT 368 (TCC).
[13] *Lloyds TSB Leasing*, above fn.1, [2013] UKUT 368 (TCC).

minority of cases, especially in the complex, tax-based world of finance leasing, are likely not to be borderline for these purposes.

The UT was only called upon to consider "main object/purpose" language in the context of section 123(4). However, it did so in a way which, if applied to the numerous UK anti-avoidance rules drafted along similar lines, could have significant restrictive consequences. As mentioned above, interest deductibility will almost certainly inform the thinking of knowledgeable taxpayers who finance transactions mainly with debt, rather than equity. Hence, applying the UT's approach, it becomes a lot harder to deny, for the purposes of the anti-avoidance test in section 441 of the Corporation Tax Act 2009 (CTA 2009), that "a main object" in incurring debt is to claim a tax deduction for financing costs, even if the borrower has major non-tax objectives too. Logically, the UT's approach should lead to that tax deduction being denied, or at least restricted under section 441 CTA 2009. Yet, in the absence of a highly artificial financing structure, such a conclusion would generally be regarded as extreme because it would usually force a taxpayer to opt for the most tax-inefficient financing outcome: equity. Lord Upjohn would be unlikely to have reached such a conclusion.

Moreover, this problem of what is and is not a "main object/purpose" cannot be easily resolved by rhetorically labelling a tax deduction for interest incurred in a commercial transaction as merely "incidental" or "the icing on the cake", rather than "a main object" of a transaction.[14] Such labelling begs the key question. The reality is that the availability of a tax deduction for financing costs will generally loom large in the thinking, structural planning and economic modelling of well-informed parties and their advisers. Only very rarely will the happy coincidence arise where a commercial transaction needs so little modification in order to claim a tax benefit that the benefit can properly be described as "incidental" or merely an "effect", not an "object".

It is fair to say that the taxpayer won narrowly before the UT. It should be stressed that the role of the UT is more limited than that of the FTT. The latter is the primary fact-finding body and, under previously established principles,[15] its decisions should only be overturned in the event of errors of law and/or any findings of fact which were wholly unreasonable. This more limited review role helps to explain why the UT took issue with aspects of the lower court's ruling and was somewhat sceptical about the substance of K-Euro's business plans, but did not ultimately feel qualified to reverse the FTT's decision on the all-important fourth issue.

A Court of Appeal hearing in this case is now scheduled. Hopefully, a more satisfactory attempt will then be made to identify when commercial transactions involving the exercise of structural choices or avoiding traps for the unwary in the tax legislation do not fall foul of rules drafted like section 123(4). There are many such rules, most of them enacted within the last 20 years, and they potentially affect a wide range of commercial transactions. After two lengthy, lawyer-intensive tribunal hearings in this particular case and detailed analysis of a mountain of evidence, their ambit is far from resolved.

[14] See, for example, certain statements in *Trustees of the Sema Group Pension Scheme v IRC* [2002] EWCA Civ 1857; [2003] STC 95.
[15] *Edwards (Inspector of Taxes) v Bairstow* (1955) 36 TC 207 (HL).

Conclusion

The UT'sdecision is a timely reminder of the breadth and subjectivity of the many targeted anti-avoidance rules (TAARs) in UK tax legislation which adopt the "main object/purpose" formulation in section 123(4). Perhaps the best known of these TAARs is section 441 CTA 2009 which applies in relation to the taxation of corporate debt transactions under the "loan relationships" code in Parts 5 and 6 CTA 2009. There is a parallel (although somewhat different) TAAR in relation to the tax treatment of derivative contracts in section 690 CTA 2009. Both of these TAARs are broadly worded although HMRC have plans to broaden them even further in 2014–15.[16]

At least it can be said in favour of these "loan relationships" and "derivative contract" TAARs that, if they apply, they do so on a "just and reasonable" basis, rather than an "all or nothing" basis.[17] However, this is not universally true of TAARs based on whether a taxpayer has a "main object" or "purpose" of obtaining a tax benefit. Despite their breadth and subjectivity, many of these operate on a "cliff edge" basis, so as to invalidate entirely a transaction if they apply. Good examples of this are section 123(4) CAA 2001 itself and the new TAAR in section 363A CTA 2009. The latter potentially affects a wide range of commercial debt restructurings.

In July 2013, the UK General Anti-Avoidance Rule (or GAAR) came into force,[18] after extensive consultation. The HMRC position is that the GAAR will only apply to the most extreme instances of artificial avoidance. Therefore there is still an important role for TAARs throughout the tax system. The writer is sceptical that in practice the GAAR will turn out to have the limited reach claimed by HMRC. However, even if HMRC are correct (and only time will tell), cases such as *Lloyds TSB Leasing*[19] are a salutary reminder of the many broad-based and subjective anti-avoidance rules which exist independently of the GAAR. They lack the procedural safeguards applying to the GAAR, and yet are clearly capable of adversely affecting transactions with a high degree of commerciality.

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[16] See HMRC consultation, *Modernising the taxation of corporate debt and derivative contracts* (June 2013).
[17] See, for example, the decision of the First-Tier Tribunal in *Iliffe News & Media Ltd v HMRC* [2012] UKFTT 696 (TC), where the court ruled that it was not "just and reasonable" to disallow a deduction, even though there was a "main purpose" of offering a "tax advantage".
[18] FA 2013 Pt 5.
[19] *Lloyds TSB Leasing*, above fn.1, [2013] UKUT 368 (TCC).

Capital allowances; Finance leasing; Overseas leasing; Ships; Tax avoidance

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