[2015] UKFTT 0325 (TC)

TC04510

Appeal number: TC/2011/03431

TC/2013/05180

Income Tax – Claim for capital allowances in respect of expenditure on scientific research - Scheme to claim the allowances for a substantially higher amount than that actually applied in undertaking such research - whether the partnership's whole activity or any part of its activity constituted trading for tax purposes – whether if so, trading losses derived from capital allowances arose in a non-commercial venture - whether pre-payments of interest on two substantial borrowings were allowable – whether the amounts borrowed had been contributed to a partnership and applied wholly for trading purposes - whether "interest" had actually been paid - whether relief was denied by section 787 Taxes Act 1988 - whether certain expenses were deductible - Both Appeals dismissed

FIRST-TIER TRIBUNAL TAX CHAMBER

THE BRAIN DISORDERS RESEARCH LIMITED PARTNERSHIP

First Appellant

NEIL HOCKIN

Second Appellant

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

Tribunal: JUDGE HOWARD M. NOWLAN

HELEN MYERSCOUGH ACA

Sitting in public at the Royal Courts of Justice, London, on 20 – 24 April 2015

Jolyon Maughan QC and Alice Mayhew, counsel, instructed by Berwin Leighton Paisner, on behalf of both Appellants

Kevin Prosser QC, David Yates and Zizhen Yang, counsel, instructed by the General Counsel and Solicitor to HMRC, on behalf of the Respondents

DECISION

Introduction

1. These Appeals related to a tax avoidance scheme promoted by Matrix-Securities Limited ("Matrix"), designed initially to repeat the type of scheme dealt with in the First-tier and Upper Tribunal decisions in *Vaccine Research Partnership*, reported at [2013] UKFTT 073 and [2014] UKUT 389 (TCC), and in which there might yet be an appeal to the Court of Appeal. The transactions, effecting the scheme, were inter-dependent and were effected on 2 April 2007. Expressed very shortly, the tax planning underlying these transactions sought to implement two concepts. One was to generate up-front reliefs by artificial steps that might enable capital allowances to be claimed for vastly more than the realistic amount that was actually to be spent on undertaking such research. The second was to arrange for additional borrowings to be incurred, almost entirely to fund vast pre-payments of interest, designed again to generate up-front tax relief that could be set against other income.

2. The First Appellant in this case was the partnership, comprised of high net worth individuals, that was promoted to undertake scientific research and designed to claim the capital allowances granted for such expenditure. We will refer to the First Appellant throughout as "the Partnership". The Second Appellant was one of the partners, whose appeal was essentially designed to constitute a test case for the separate points (geared mainly to claims for interest relief) affecting the individual partners, as distinct from the partnership. We will never refer to Mr. Hockin by name, but simply refer to "the partners" when considering issues affecting the individual partners as opposed to the Partnership.

3. In making his opening submissions, the Appellants' QC summarised the transactions by using simple numbers in which the capital contributed to the Partnership was treated as 100, and thereafter, as amounts had either been borrowed to fund that contribution, or amounts contributed were applied in different ways, the summary referred to the percentage of the 100 involved in each particular transaction. This was not only simple and clear, but it also self-evidently indicated the relationship of one figure to another, and throughout this decision, we will use the same numbers which we will always indicate by presenting them in bold type and italics. We will periodically insert in brackets, after the example figure, the actual amount involved at each step.

4. The clearest way to explain matters in this Decision will be:

- firstly to describe, in bare outline and not necessarily with total accuracy, the original proposed scheme and the hoped for tax consequences of the scheme, prior to very material variations that were made to counteract a change in the law announced on 2 March 2007;
- secondly, we will describe the changed steps in the scheme, consequent upon the March 2007 law change and the hoped for tax effects of the revised scheme that was implemented on 2 April 2007;
- we will then list the various challenges, 9 in all, mounted by HMRC in relation to the efficacy of the scheme that was actually implemented, and will mention the one further point that may in due course have to be considered, but that we were asked to ignore in this Decision albeit that we were specifically asked to record that it remained an undecided issue;

- we will then expand on the facts, where relevant, incorporating the material evidence and the results of cross-examination;
- having been requested in the strongest terms by both parties to make clear findings of fact in relation to issues that the respective parties indicated that they wanted us to address, we will give some findings of fact, though in relation to some issues we will indicate why we consider either any finding to be completely irrelevant or why we consider it almost self-evident that no reliable finding of fact can be provided;
- we will then give our decisions on each of the 9 points in dispute.

5. Our decision on all but two of those 9 issues is that the Appellants' appeals fail in relation to each point, the two exceptions being rendered irrelevant by our decisions on one or two of the points decided in favour of the Respondents.

The original proposed scheme, essentially replicating the steps in the Vaccine Research scheme

6. The original objective of the tax planning was to identify an area of scientific research where the cost of a conventional research programme would be approximately ***100***, but where the technology, expertise, systems and data bank held by one particular company, would enable the relevant research to be undertaken and accomplished by that unique company for a vastly lesser sum, albeit that the company in question would retain 90% of any net royalties derived from the work programme to reflect the value of its special expertise, data bank etc held prior to the commencement of the research.

7. Without referring to the full detail of how the scheme might have proceeded, the original scheme envisaged that the partnership would pay ***100*** to a special purpose vehicle or SPV (in fact the Jersey company owned by a charitable trust, Numology Limited ("Numology"), that performed roughly this role in the *Vaccine Research* scheme). The ***100*** was said to be the reasonably verified amount that various third party providers would have charged for undertaking the research work in the then conventional manner. Under the contract under which the Partnership paid the ***100*** to Numology, Numology contracted to undertake the work itself or through the identified sub-contractor, namely the company with the special expertise, systems and data bank referred to in the previous paragraph. That company was the Australian company, BRC Operations Pty Limited ("BRC"). In a research sub-contract, Numology then paid ***6*** to BRC to undertake the work programme that Numology had undertaken to perform or procure for the Partnership. The further terms of this arrangement were that BRC had licenced its existing intellectual property, its patents and knowhow, in relation to the relevant area of scientific research, namely treatments for certain brain disorders, to Numology, and indirectly to the partnership for £1, and that had then been licensed back by the Partnership, first to Numology in return for a combination of fixed royalties and fluctuating royalties, and then sub-licensed by Numology to BRC in return simply for fluctuating royalties equal to 10% of the net royalties eventually derived from the improved and enhanced intellectual property following the work programme undertaken by BRC. Under this sub-contract arrangement, the deal with BRC was simply that if the completed work programme delivered royalties or any other reward, BRC would retain 90% of the net revenues, whilst 10% would flow to Numology and on to the Partnership

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

obligation to pay the fixed royalties for which it alone was liable, as mentioned in the previous paragraph.

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

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

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

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

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

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

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

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

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

17. Immediately the partnership received the ***57***, by way of early receipt of the fixed rentals, the ***57*** was distributed to the partners, though in fact held at all times in an account in one or other bank. ***40*** was then immediately paid to Schroders, fully discharging the full recourse liability to pay the entirety of the interest on the Schroders loan. The interest rate was of course considerably higher than that under the BoS borrowing because of the non-recourse terms as regards the principal under the Schroders loan, the BoS loan having no such term.

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

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

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

21. The essence of the revised tax planning was of course that if there was a limit on the amount of losses derived from capital allowances that could be set by the partners against other income, it was preferable to diminish the net claim for such losses by arranging for the partnership to have a receipt of income of ***57***, such that the claim for the net loss was reduced (ignoring the claim for fees and expenses) to ***39*** (***96*** minus ***57***), with the claim for tax relief then hopefully being augmented by relief for ***57***, the entire receipt of ***57*** being applied in pre-paying interest on the Schroders and BoS loans.

22. We have mentioned that there was some considerable confusion as to where and how various fees and expenses were met. One suggestion was that the original summary in which we had been told that ***4*** had been paid as fees and expenses at the partnership level, as mentioned in paragraph 13 above, and only ***1*** paid as fees and expenses by Numology, as mentioned in paragraph 20 above, may have been wrong. It may have been that the numbers were switched and that only ***1*** was paid by the Partnership at the top level, and ***4*** not ***1*** was paid by Numology. Were this the case, and we will deal with expenses below, it would obviously follow that the basis on which tax relief would have been claimed by the Partnership for the expenses incurred at the Numology level would simply be that more (***99*** rather than ***96***) had been paid by the Partnership for scientific research.

Further more detailed points in relation to the planning

23. It will assist to refer to five further points in relation to the basic steps that have some bearing on the issues that we must decide.

24. We have described above the manner in which the borrowings from Schroders and BoS were applied in contributing capital to the partnership, followed by the payment of ***57*** back to the Partnership, ***29*** to the fixed deposit that secured Numology's remaining liability to pay fixed royalties and thereafter the partners' liability to repay the principal of the BoS loan, and ***3*** for the assignment of the limited recourse right to the repayment of the principal on the Schroders loan of ***43***. As many readers might assume, the relevant moneys advanced by Schroders and BoS were always held in accounts in the relevant lending bank, whether the accounts were held by the Partnership, the partners or Numology, and there was no discretion for any of the moneys borrowed to be applied otherwise than in accordance with the steps outlined above.

25. The next detailed point to mention is that BRC did have an option to acquire the licence from the Partnership. This essentially had nothing to do with the tax planning, and it was not envisaged that the option would be exercised. We were told that the purpose of the option was simply that if a bid was made for BRC, it was contemplated that the value might be diminished unless BRC reacquired all the intellectual property rights directly, notwithstanding that it anyway had the benefit of retaining 90% of the net revenues in any event.

26. There were, however, two odd features in relation to the option terms. One was that the option price was market value, or if the research programme had not been completed, the higher of market value and the amount paid ***by the Partnership to Numology*** for scientific research. We were told by the Appellants' counsel that the option price in this latter situation was set at this high price to prevent BRC from acquiring the intellectual property rights at an early stage when they might have a low market value. It was nevertheless distinctly odd (albeit that the reason for the oddity is fairly obvious) that the floor price under the option was geared to what the Partnership had paid Numology, rather than what Numology had paid BRC for the 10% interest being acquired. We will refer to this point again in due course.

27. Another somewhat related oddity in relation to the exercise of the option (though again obvious in reality) was that if the option was exercised, such that the Partnership no longer held the intellectual property rights, nothing stopped Numology from remaining liable to pay the outstanding balance of the fixed royalty payments, notwithstanding the technicality that the Partnership would no longer hold any intellectual property rights commanding the right to royalties.

28. The third point to mention is that there was a term in the sub-contract under which Numology contracted with BRC for the performance of the research programme that if BRC failed at some point to undertake the research, then some calculated balance of the initial payment made (i.e. of the ***6***) had to be repaid by BRC to Numology. There was no equivalent provision in the initial contract between the Partnership and Numology, and indeed the contract provided that in no circumstances was the payment of the ***96*** to be refundable. One can only imagine that the explanation for this was that, had a refund provision at the top level been geared to a repayment of the ***96***, Numology could not have agreed to any such term whilst, had a refund provision at that level been geared to some remaining portion of the ***6*** payable for the research at the lower tier level, this would have been somewhat embarrassing in the context of the Partnership's claim that it had incurred scientific research expenditure of a vastly greater amount.

29. The fourth point to mention is that all parties, including the partners in the Partnership, were aware that all the steps that we have now described were inter-dependent and that all were to occur. Nobody was in any doubt that in fact only ***6*** would be paid to BRC for the actual research that was to be undertaken.

30. The final point is that the Matrix marketing document to potential partners made it clear that the scheme was a tax scheme. There was some dispute between the Respondents' counsel and the witness for Matrix, Mr. John Hardy ("Mr. Hardy") as to whether the scheme was a "tax shelter scheme" (as the Respondents' counsel termed it) or a "tax efficient investment" (as Mr. Hardy described it, without doubtless intending to create any impression that the transactions were investment rather than trading transactions), but the reality is that it was essentially sold to partners as a scheme in which the up-front tax savings were critical and in which partners could take the view that the value of those allowances plus the fixed and certain receipts rendered the scheme beneficial. There was in other words no need for the intending partners to seek to value the speculative right to the fluctuating rentals, because the other features of the scheme justified participation and the potential of royalties was just an added benefit.

31. We have so far not described what the scientific research all related to and will of course do so in due course. We should, however, record Mr. Hardy's evidence to the effect that some of the partners may have been particularly interested in the research, and some may have had relatives suffering from the mental illnesses that the scientific research was directed to furthering.

The various challenges to the tax expectations on the part of the Appellants mounted by HMRC

32. The Respondents advanced each of the following challenges against the various steps in the scheme.

1. The first was that elements of the documentation were a sham. In particular the term in Clause 3.1 of the Research Agreement between the Partnership and Numology was a sham when it provided that *"Numology shall by itself or (subject to the following provisions of this clause 3) through the Appointed Sub-Contractor undertake for the Partnership a programme of research work on the terms of this Agreement"*. There was no intention that Numology would or could undertake the project itself so that the first limb of the sub-Clause that we have just quoted was false. Were the sub-clause to match the reality that inevitably Numology's obligation was simply to procure that BRC would undertake the research programme under the sub-contract, it could not then be asserted

that ***99*** or ***96***, or indeed anything more than ***6***, was to be paid for, and incurred in procuring, the scientific research.

2. If the sham argument was wrong, then it was still contended that the claim for capital allowances could not be for more than ***6***. Section 437 of the Capital Allowances Act 2001 provided that *"Allowances are available under this Part if a person incurs qualifying expenditure on research and development."* Viewed realistically the partnership could not have incurred, and did not incur, expenditure on scientific research in any figure in excess of ***6***. It was plainly known by all parties that no more than ***6*** of the Partnership's capital would ever in fact be applied in undertaking scientific research; there was not the slightest reality to the proposition that Numology would undertake the research in what might be called the more traditional and costly manner in which the relevant cost might have been ***100***, and the Partnership certainly knew, when it paid ***99*** or ***96*** to Numology, then at the absolute insistence of the two banks, ***57*** was going to come straight back to the Partnership and ***29*** and ***3*** were immediately to be applied in transactions that had nothing to do with scientific research. Accordingly, sham aside, it was unrealistic to say that any more than ***6*** had been incurred on scientific research.
3. Two contentions were advanced in relation to the issue of whether the Partnership was trading. One was that it was not trading at all. The other (the conclusion reached by the First-tier Tribunal and upheld at least as being tenable by the Upper Tribunal in the *Vaccine Research* case) was that the trade extended only to the marginal activity related to the sub-contracting of the research function to BRC. The tax implications of the two contentions are of course different. We will treat the first of the two contentions as the claim that the Partnership's activity was substantially a non-trading activity, albeit that the sub-contracting of the research function was a trading activity.
4. The fourth issue is the second variant, namely that even the limited research function in relation to the ***6*** was a pure passive acquisition of a high-risk net income stream, over which the Partnership had no control, and that this was thus an investment activity, and not a trading activity at all. This ground, though not that in 3 above, would altogether undermine the claim for capital allowances.
5. The fifth contention assumed that there was a trading activity, at least in relation to the research activity conducted via BRC for the payment of the ***6***, but then asserted that section 384 Taxes Act 1988 precluded relief for the loss because the trade was not *"being carried on on a commercial basis"*. It was contended, partly at least on the basis of a public announcement made by BRC in early 2007, that the research project was a risky project that might realise nothing or might realise huge revenues. HMRC contended that, while this same "high risk" feature was relevant in relation to the trading issue in the first place, it was also material where the decision was that there was a trading activity in that the activity of placing a bet on an uncertain outcome was non-commercial. Section 384 was not confined in its application to hobby farmers and amateurs, but could be invoked in the present type of case.
6. Issues 6, 7 and 8 all related to the relief claimed for the pre-payments of interest on the two bank borrowings. Issue 6 was the proposition that under section 362 Taxes Act 1988 none of the interest paid on the Schroders and BoS borrowings was allowable because the section provided that relief was only available *"on a loan to an individual to defray money applied …. in contributing money to a partnership by way of capital or premium, ….. where the money contributed or advanced is used wholly for the purpose of the trade"*. In the present case, where the money borrowed was in blocked accounts and it had to be applied in the manner indicated above as regards the disbursement of the ***57***, the ***29*** and the ***3***, it was clear that unless the entire activity of the Partnership was held

to be a trading activity, none of these applications would constitute "use wholly for the purposes of the trade".

7. The second interest contention was that the dealings with the Schroders loan were very reminiscent of the 1970s style pre-payment of interest schemes, and that under the decision in *Cairns v. MacDiarmid (Inspector of Taxes)* [1983] STC 183 the prepayment of interest was simply not a payment of interest at all.
8. The third interest contention was that if the points in both paragraphs 6 and 7 were wrong, then interest in relation to both borrowings was disallowed under section 787 Taxes Act 1988.
9. The final issue for us to determine, that we will deal with in a somewhat inadequate manner, is the issue of whether fees and expenses are deductible. In one scenario, it is possible that this issue may have to be referred back to us for further consideration.
10. The issue that we were asked to flag, but not to consider, is the question of whether the receipt of the ***57*** by the partnership was taxable. This appears to revolve around two considerations. One is that when the Partnership claimed its various losses, the Closure Notice issued by HMRC indicated that there were neither profits nor losses in the relevant year on the part of the Partnership. HMRC suggested that this meant that there were neither trading profits nor trading losses, but that the Closure Notice should not be taken to indicate that HMRC accepted that if the capital allowances were wholly disallowed, the fixed royalty payment of ***57*** would not be pure income as distinct from trading profit. The Partnership claimed that the Closure Notice meant that the ***57*** would not be taxable. The alternative basis on which the ***57*** might escape tax would either be on some form of semi-concession conceded by HMRC (that HMRC indicated that they were not presently minded to grant) or it might be that on some re-analysis of the transactions in this case, the payment of the ***57*** was just some form of reversed contribution and not taxable income. Those points are the ones that we are directed not to consider, though it is obvious that the original basis on which the transaction was undertaken was that all the fixed royalties would be taxable income, a classification that was perfectly understandable on the basis of the claim that the entire amount paid to Numology by the Partnership qualified for capital allowances. We will of course not consider this issue.

The further facts, the evidence and the results of cross-examination

33. Evidence was given by Mr. Hardy on behalf of Matrix in relation to the structuring of the scheme, the origin of the contact with BRC, the role of Numology, the survey undertaken to ascertain how much it would have cost to undertake the relevant research in a traditional manner, the data bank, efficient procedures and other pre-existing research that enabled BRC to conduct the research so much more cheaply than "tradition" suppliers, the intended scope of the project, and the prospects of royalties being received.

34. The Respondents' counsel challenged Mr. Hardy on occasions for being somewhat evasive. Mr. Hardy had clearly been heavily involved in structuring the scheme, and we concluded that he was both competent and basically honest. In summarising the facts in more detail, we will mention those areas in which the Respondents particularly criticised his evidence, and his tendency to be slightly evasive.

35. Mr. David Williams ("Mr. Williams"), a partner in the Boston, Massachusetts firm of MedPharma Partners ("MedPharma"), was called to give expert evidence, principally in relation to the likelihood of success of the BRC project and the likely revenues to be derived from the research, of which 10% of the net revenues were to flow to the Partnership. The Respondents' counsel challenged Mr. Williams' evidence as regards his impartiality to give

expert evidence on several related grounds. He also criticised the relevance of his evidence because his expert's report referred to the expectations of success judged in 2014 (as had been requested by the Appellants who had called him as an expert witness), whereas the only relevant point, with some potential relevance to the legal question of whether the Partnership could sustain that it was trading, was entirely how the Partnership had evaluated the whole project, the standing of BRC, and the prospects of success, all back in 2007.

36. As regards the challenge of lack of impartiality,MedPharma had been associated, it seemed, with BRC for some time and in BRC's words, was assisting in promoting BRC's repute and standing in the USA. MedPharma had done work with BRC for a number of years and it was MedPharma that was commissioned by BRC (but essentially for Matrix) to undertake the survey in which about 60 pharmaceutical companies, universities and research specialists were asked (around late December 2006 and very early 2007) to provide their quotes for performing parts of the project that BRC would eventually undertake, albeit using the so-called "traditional methods". The purpose of this project was of course to establish credibility for the proposition that when the Partnership paid ***96*** or ***99*** to Numology in return for Numology's commitment to undertake or procure the research, either of those amounts could be sustained as a fair price to pay for the research, and certainly reflected what the research would ordinarily have cost.

37. In addition to having been heavily involved in this way with BRC, the Respondents' counsel also challenged Mr. Williams for not having divulged that on two occasions he had been granted share options by BRC, the second grant being because the first options had not been exercised and had lapsed. He had also co-written a chapter in a publication with Dan Segal ("Mr. Segal") of BRC, the third witness who gave evidence in relation to BRC's role. Mr. Williams said that the share options were of no great significance and that the writing of the chapter was an isolated incident and that the chapter had actually attracted little attention.

38. There was no doubt that Mr. Williams was an impressive witness. He appeared to have a full grasp of the facts and his answers were always carefully delivered and convincing. Had he been totally impartial, we would have considered him to be a competent witness of integrity whose evidence we would have largely accepted. We do, however, accept that the criticisms of lack of impartiality appeared to be valid in the light of Mr. Williams' evident enthusiasm for BRC and its relevant work programme. Whether a wholly impartial witness would have been more cautious is impossible to say. We certainly also accept that the relevance of his evidence was greatly reduced by the fact that he was largely addressing the value, and revenue potential, of the BRC project in 2014, and not in 2007.

39. In due course we will comment more generally on the evidence, and any realistic conclusions that we can draw from it on the fundamental issue of whether Matrix and the Partnership approached the BRC project with the appropriate caution and diligence, and whether they had a genuine and supportable belief in the likelihood of receiving significant fluctuating royalties.

40. The final witness was Mr. Dan Segal of BRC. He was again a very impressive witness. He was a businessman, well familiar with structured projects, and not first and foremost a scientist. We will incorporate his evidence into the more detailed facts that we will now record.

The more detailed facts

The Scheme's Origin

41. The origin of the present scheme plainly derived from the objective of repeating the *Vaccine Research* transaction. Mr. Greg Stoloff of PepTcell (the sub-contractor in the *Vaccine Research* scheme that had performed the role conducted by BRC in the present transaction) happened to be a small shareholder in BRC, and he suggested to Mr. Segal that Mr. Segal should approach Mr. Hardy and see whether BRC could usefully raise finance for its own brain research project in the fashion that PepTcell had done in the *Vaccine Research* scheme. Mr. Stoloff presumably contemplated that BRC's extensive data bank and other expertise in relation to mental illnesses would place it in an ideal position in order to be the sub-contracting company for research that when performed by others (pharmaceutical companies universities and research specialists etc.) would cost vastly more.

BRC, brain disorders and the research project

42. BRC was in 2006 a subsidiary of a relatively small but listed Australian company which, as the B and the R in its name indicated, specialised in research into brain illnesses. While small, it nevertheless appeared to be highly regarded and efficient. We were told of many world famous pharmaceutical companies that had been or were clients of BRC; Mr. Keating, the former Prime Minister of Australia, was at the time on the Board of BRC's parent company, and whether we have some slight misgivings about Mr. Williams' total impartiality, it was absolutely clear that Mr. Williams, the impressive research specialist in the States, thought very highly of BRC.

43. We were told that the market for drugs and treatments for brain disorders was a very difficult market, from which many companies had retreated, and that there was yet a very great deal to be learnt about the workings of the brain and the brain's various malfunctions. BRC, however, had made this subject its particular speciality, recognising that if contributions could be made to diminishing the problems and the resultant costs and losses to industry of depression and other mental disorders, BRC might make a great contribution, and might indeed realise very substantial income from marketing the product of its research.

44. It was not particularly material for us to understand quite what the project conducted by BRC with the aid of the ***6*** (£7.7 million) injected by the Partnership and Numology involved; nor to understand the various benefits, efficiencies, and in particular data that BRC possessed before commencing the study that rendered it such a suitable candidate to undertake the further research and that so diminished the potential cost. We, and the Respondents themselves, both accepted that BRC was particularly well placed to undertake the research, and nobody doubted that BRC's activity was entirely genuine. In bare outline, as we understand it, the essence of the project was to undertake research into the effect of three of the leading drugs used to treat depression and the one leading drug used for the treatment of Attention Deficit Disorder ("ADD"), and then to compile a databank illustrating the relative advantages and disadvantages of each of the drugs in various circumstances and for different patients. As we understood it, the hoped for product of the work would be guidelines that would enable health providers, major employers, doctors and hospitals to deal more swiftly and efficiently with the two relevant brain disorders, and at reduced cost. Since we were told that one in five people would suffer from some sort of brain disorder in their lifetime, and were also told (entirely predictably) that the USA was by far the major market for such drugs and the technology that BRC was endeavouring to create, the possible commercial worth of the study was readily understandable.

The deal between BRC and Matrix

45. Mr. Segal came to the UK for much of the first three months of 2007 and negotiated the transaction, principally with Mr. Hardy.

The exercise in obtaining the third party quotes

46. One respect in which BRC assisted Matrix with the promotion of the scheme was by engaging MedPharma to undertake the study involving the 60 institutions, in order to estimate the cost of procuring the relevant research by traditional methods. It is obvious that this research was not central to what was actually to be done, but simply vital if in any way the tax scheme's success was going to depend on the proposition that by paying Numology ***96*** to undertake the research, this was a fair price. The exercise of approaching the 60 providers was undertaken in a short period and although some addressees were given two weeks in which to respond, we were certainly told that Harvard University, for instance, was given merely three days to respond. It was quite impossible for us to determine how seriously the addressees took the questionnaire that they were sent. Some might have quoted high prices in order not to bother with the project or to make considerable profit if it proceeded. In the case of others, it was impossible to know whether their quotes could have been improved, had the exercise actually been "real and serious", by suggesting possible savings and efficiencies.

47. Mr. Hardy suggested that one other possible relevance of the exercise in obtaining these quotes was that the quotes did assist Matrix in effectively valuing BRC's pre-existing database and other benefits, and it thus assisted in gaining confidence that the ***6*** was the right price for Numology to pay BRC.

48. We are far from convinced that the exercise of obtaining all the third party quotations was that material in pitching or verifying the price to be paid to Numology. BRC's evidence was that BRC had a considerable head start in relation to this project. They wished to pursue the research that was being discussed with Matrix. As a relatively small company, they would have some difficulty in raising funds through the market, and the Matrix proposal was therefore attractive. They were, however, prepared to proceed with a research project on the basis that the funding derived from Numology would merely be sufficient, were BRC's numbers and calculations correct, to pay the third party costs that BRC anticipated that they would have to incur in proceeding with the project. BRC were prepared to bear all their in-house costs, and ready to provide to third party providers all assistance and support that they could, all at their cost. It did not appear, therefore, that there was a realistic case for saying that the proposed charge to Numology of ***6*** was excessive, or that Matrix had much standing to negotiate that suggested charge down.

The split of royalties

49. The other critical term in the deal between Numology and BRC was that by only paying ***6***, Numology was only to receive 10% of the net royalties that the project might generate, BRC retaining the 90%. There was absolutely no evidence as to what the "traditional" providers might have charged had they been offered the choice of a lower up-front payment in return for their retaining or receiving a share of eventual royalties, and of course there was no evidence as to what BRC would have charged, had they been prepared (which we very much doubt) to do a deal along the lines that all royalties were to belong to Numology. Accordingly, the assistance that Mr. Hardy might have derived from the exercise of obtaining the traditional cost quotes from the 60 institutions would appear to have had little bearing on verifying anything about the BRC terms, such that it was really undertaken solely to buttress the Matrix tax planning.

The scope of the project – mental disorders and drugs

50. Another very relevant point in relation to the project and its scope is that while the project eventually focused on the effect of 3 drugs in relation to depression and 1 in relation to ADD, at earlier stages and indeed even very shortly before the scheme was implemented, there had been talk of extending the research to schizophrenia and bipolar in addition to depression and ADD, and there had been talk, in relation to depression and ADD, of testing the effects of 8 and 3 drugs respectively instead of the eventual choice of 3 and 1. There was considerable debate with the witnesses before us as to whether the project would have been better had there been the funding to research either more drugs than the 3 and 1, or one or both of the other two conditions. It was certainly suggested that just the two conditions and the 3 and 1 drugs were adequate, and that quite possibly the suggestion of extending the depression study to 8 drugs might have been commercially unattractive because the added costs would have outweighed the added information and benefit. The point that is, however, fairly decisive is that the eventual driver that governed the scope of the project, and the conclusion that the project would address just the two conditions and 3 and 1 drugs respectively, was the inability of Matrix to raise additional funds. We should record that BRC took their role in the project very seriously and we find it impossible to believe that BRC would have agreed to a project that was not at the very least satisfactory and promising. We should also record the Respondents' criticism that, had there been any real prospect of adding more brain disorders or more drugs to the study, no real attention appeared to have been given to them by Matrix on behalf of the Partnership. This matches a criticism made by the First-tier Tribunal in the *Vaccine Research* case, albeit that it may here be less material because we are not convinced that there was a serious prospect of making the further additions to the project.

The duration of the project

51. BRC insisted that BRC should have up to 15 years in which to complete the project. This was doubtless far from unacceptable to Matrix if it resulted in the balance of the fixed royalties above the ***57*** being spread over a relatively long period. From BRC's perspective, the insistence was entirely understandable. Mr. Segal said that BRC did not want to be put under pressure were the programme to be running behind schedule, thereby having itself to incur additional costs.

The component parts of the research programme

52. The research agreement between the Partnership and Numology and the sub-contract research agreement between Numology and BRC both contained Schedules, detailing the numerous individual matters to be researched in a given order. Each was priced in the Schedules. Naturally the aggregate pricing under the top level contract matched the price paid, i.e. ***99*** or ***96***, and the pricing under the sub-contract matched the expenditure incurred at that level by Numology, i.e. ***6***. The detailed sub-division in the price in the top level contract was of course wholly artificial, and even at the lower tier level Mr. Segal very sensibly said that he and BRC were really only interested in the aggregate figure. A particular artificiality was that in the first phase of the project, where certain preliminary matters were identified in which there was no realistic suggestion that BRC's technology would significantly reduce costs, there was still a 22% disparity between the figures, those at the lower level being the lower costings. It emerges that the somewhat embarrassing explanation for this disparity was that the cost numbers in each original version of the Schedule in this early phase had been pitched at the same level, though one was in US

dollars, and the other in Australian dollars. Since the US dollar stood at a 22% premium to the Australian dollar, when both figures were converted into sterling, the resulting figures in sterling were 22% apart. While this was embarrassingly unrealistic, it has to be said that the entirety of the Schedule in the top level agreement was fiction or window-dressing, while the sub-division of the pricing at the lower level was largely irrelevant if BRC paid regard principally to the total figure.

Control

53. The research contracts made it quite clear that BRC had total discretion over how it undertook the project. It had to give periodic reports to Numology, and so to the Partnership, and Numology engaged two scientists, Stephen Koslov and Dr. Norman Moore, to enable them to evaluate the reports. Both scientists had been introduced to Numology by BRC (showing a certain lack of attention to objective analysis), and while they and Numology could make suggestions to BRC as to how the work project should proceed, nothing diminished the absolute discretion accorded to BRC as to how to pursue the project.

Matrix due diligence in relation to BRC and the prospects of generating net royalties

54. Whilst the diligence with which Matrix verified the general standing of BRC, and weighed up the chances that the research project would itself generate net revenues, has nothing to do with the capital allowances questions that we must consider, the Respondents' counsel was right to say that these matters will have a bearing on the question of whether the Partnership's activity was a trading activity or purely an up-front capital payment for a highly speculative net revenue stream over which it had no control, such that arguably the Partnership's activity was not a trading activity.

55. Matrix undertook some due diligence seriously. To the credit of Mr. Hardy, Mr. Segal said in cross-examination that Mr. Hardy had been meticulous and that he had become, perhaps in the nicest sense, "a bit of a pain." He had asked question after question. We ourselves noted that throughout the hearing there was no suggestion by anyone that there was anything deficient in the whole operation of BRC, and in other words no failings that had been concealed by inadequate due diligence in relation to BRC's operation.

56. On the more difficult question, however, of how promising it was that the project would deliver net revenues, we must be more cautious. Mr. Williams' evidence suggested that as at 2014, things looked relatively promising. It seemed that FDA approval for the database or other end product of the project was imminent, and that because of the importance of the project and because it was not "high risk" (in other words it did not relate to some novel drug that might have unforeseen side effects), FDA approval for the project was being fast-tracked. Certainly today, therefore, the prospect that there will be net revenues looks reasonably realistic, and certainly higher than the chance, with tax based film schemes, that there will ever be receipts of the ever-illusive "B rentals".

57. This is not to say that the prospects in 2014 could have been or had been anticipated in 2007. We were certainly told that there was not much concern that newly-discovered drugs would sweep the market and suddenly render the BRC research obsolete. It was thought that the long-standing and proven drugs would always hold a very reasonable market share. We were told that the market share for the 3 in relation to depression in 2007 was 30%. There were, however, numerous other uncertainties. The databank would only be marketable commercially if its cost was less than the efficiencies and savings that it generated. And it was speculation in 2007 to predict whether this would be so.

58. In 2007, BRC produced a very thorough 22-page paper headed *"BrainResource – Personalised Medicine 2007 Update"* in which page 20 dealt with the iSPOT project (the name given to the project undertaken with Numology). This carefully worded paper contained the following two highly relevant paragraphs:

> *5.6 **Hypothetical for commerciality of iSPOT***
>
> *iSPOT is focused on identifying validated Markers for Depression and ADHD that would assist the diagnosis and treatment. If iSPOT is able to deliver Markers which expedite matching the right treatment to the right individual and if that marker can be sold at a price of less than the cost saving (clinical visits, lost productivity, etc) resulting in widespread use, this would represent a very significant market opportunity.*
>
> *We can only speculate as to worth of such a market, with extrapolations about new markets in as difficult [a] field as the brain fraught with risk."*

59. We were also shown various tables, suggesting that the royalty earnings in relation to Depression alone, and in the USA alone, might be in the region of US $400 million a year. It was, however, sometimes unclear whether various figures referred to gross receipts or net royalties, to royalties in relation to both conditions or just depression and whether they dealt with the USA alone or the world market. More relevantly, however, and the passage that we have just quoted appears consistent with this observation, it appears fair to say that in 2007 there were so many uncertainties that figures of projected earnings inherently involved so many unproven assumptions that they were of very limited value. We are inclined to agree with the Respondents' counsel. In 2007, this was a bit of a speculation. There might have been huge returns; there might have been nothing. As a bet, it certainly seemed and now seems, significantly better than the bet on B rentals in tax-based film schemes, but it was hardly a prospect that could be valued in any reliable manner.

60. It is also relevant to note that this inability to reach any very helpful decision in relation to the prospects of significant royalties, all judged as at 2007, is not a unique failing of the Tribunal, but the very reason the present scheme was believed to be so attractive. It was marketed on the basis that the up-front perceived tax saving, coupled with the secured fixed royalties, made the project an attractive project for investors, and saved investors having to take any serious view about the prospects of receiving any of the 10% fluctuating royalties. We also note the matching obvious point that while the following form of finance raising was not the sort of transaction that would have interested Matrix in 2007, nobody ever dreamt, it seems, of inviting investors simply to contribute some equivalent of the ***6*** straight to BRC without any of the frills, in return for a corresponding proportion of net royalties. That we assume was too risky an expedient to offer to investors.

The role of Numology

61. We consider it realistic to assume that Numology was a vehicle, whichever charity owned it, effectively promoted by Matrix to perform various roles in relation to the *Vaccine Research* scheme and the present scheme. It would have performed no role in the negotiations and would presumably have just considered whether the role assigned to it was legal, risk free and hopefully potentially profitable for the relevant charity that technically owned the shares.

62. The Respondents' counsel raised two points in relation to Numology that we should address.

63. It had been suggested by Mr. Hardy that Numology was not needed for a commercial or UK tax purpose, and that all the transactions could have been put through BRC. He went on to suggest that it was perceived Australian tax difficulties that led to the involvement of Numology. The Respondents' counsel disputed this and said that there was no evidence to support it.

64. Whilst there was indeed no evidence on this subject, we imagine that the Partnership's objective of claiming capital allowances for ***99*** or ***96*** would still have required that amount to be paid "for scientific research", had BRC been the counter-party, and we can imagine that that might indeed have occasioned Australian difficulties, when BRC would have only been applying ***6*** in genuine research. Certainly from the Partnership's perspective, and thus from a UK perspective, the fiction of ostensibly paying the high price for scientific research was rendered somewhat more credible if the price was paid to an intermediate, such as Numology, ostensibly for it to undertake the research, so that the various numbers, the ***57,*** the ***29,*** the ***3*** and the ***6*** could all be "behind the curtain" so to speak, when addressing the claim at the top level that ***99*** was paid for scientific research. Accordingly we can see that Numology may also have somewhat assisted, or possibly been vital to, the UK tax planning. Numology may even, as another possibility, have initially been party to the present transactions prior to 2 March 2007 at which point it was doubtless intended to become a partner in the Partnership, a detail in the earlier scheme that we have hitherto ignored.

65. There is another aspect of Numology's involvement that calls for comment. The feature that, in return for a payment of ***3***, the limited recourse right to the repayment of the principal in respect of the Schroders loan has been assigned to Numology, is rather curious. The Respondents' counsel asked Mr. Hardy whether there was any commercial reason for this and while there was no clear answer to that question, the answer appeared to be that there was not. The effect of this loan having been assigned to Numology is of course that if the project is successful, and there are significant payments of 10% royalties, Numology will receive the £53.4 million by way of debt repayment. Furthermore, since this will be paid out of post-tax royalties distributed to the partners, who we can assume would be paying tax at 45%, the gross royalties required by the partners fully to discharge the Schroders loan would be approximately £97 million, which in turn would require the net royalties generated at the BRC level (i.e. the 100%) to be of approximately £1 billion.

66. On the reasoning that there may have been no commercial reason for the Schroders loan to be assigned to Numology, we can only speculate about two possible explanations for this rather extraordinary situation. One possibility, of course, is that it was thought (with very real credibility), that the analysis would have been that no interest had been paid at all, pursuant to the decision in *Cairns v. MacDiarmid,* had the ***3*** been added to the ***57*** and then paid by the partners straight to Schroders to discharge the principal immediately after the pre-payment of the interest. Accordingly the tax planning in relation to pre-paying the interest would have been undermined. In the alternative, and assuming a suggestion that the limited recourse right to the repayment of the principal should be left with Schroders, one can only assume that the response to any such suggestion by Schroders would either have been that this was not a risk that Schroders, as a bank, was interested in taking, or else it would seem that Schroders must have regarded the chance that the then present value of the future royalty stream was worth more than ***3*** to be low. Whatever the explanation for the strange manner in which this potential value was effectively gifted to Numology for no obvious reason, there seems to be no commercial explanation for it, and the tax suggestion may well represent the truth.

Findings of Fact

67. A strange feature of these Appeals has been that, while we consider that the outcome of both Appeals depends entirely on legal issues, and the application of the relevant principles to some simple and indisputable facts, all parties have placed great emphasis on the request that we make numerous findings of fact. In total, we received 67 pages of submissions, solely directed to these requests.

Five questions posed by the Appellants

68. We start this exercise with five questions posed to us by the Appellants. They were as follows:

> *"(1) Did the Partnership pay the "right price" for the Project Works?*
>
> *(2) Was it commercial to pay that price for the Project Works?*
>
> *(3) Could the Partnership have purchased the Project Works for £7.7m (i.e.* ***6****)?*
>
> *(4) What fee was paid to Matrix Services and is it deductible?*
>
> *(5) How have the Project Works progressed?"*

69. HMRC said in their response paper, replying to the Appellant's request for findings of fact, that:

> *"The first 3 questions miss the point. The only question the statute asks is what expenditure was incurred on R & D?"*

We agree with that response. In addition and in relation to question 4, while we have said that our treatment of the whole expenses issue will be slightly flawed, and that this topic may have to be remitted to us, we consider that the expenses question is relatively insignificant. Beyond that we will explain why we consider that whatever fees were paid to anyone, they were all non-deductible. As to question 5, we fail to see that this has any relevance whatsoever.

70. Reverting now to the first three questions, our starting point is to ignore the issue that we will deal with in our Decision as to whether the Partnership's research contract with Numology was a sham, and address the first three questions on the basis that the Partnership had paid the high price for scientific research.

71. While the Appellants claimed that the Respondents had levelled little criticism at the actual conduct of the study for ascertaining the cost of pursuing the research study by traditional techniques, we do criticise the exercise. It was conducted in a very short and rushed time-frame. No effort was made to discuss efficiencies with the various institutions that did reply to the questions, and we have no idea whether some might have provided top-end quotes in order not to be bothered with the project. Perhaps more significantly, we note that whilst the Partnership purported to try to ascertain the cost of the research programme undertaken by traditional methods, no attention was given to the fact that the Partnership was plainly aware that one entity, BRC, purported to have systems that would enable it to perform the same research very much more cheaply. So why is it commercial to proceed with the research in a manner that of course the Partnership in reality had not the slightest intention of pursuing , when the Partnership knew of the less costly alternative?

72. When the Matrix scheme was based on the notion of reducing unacceptable risk that would have dissuaded investors and partners from simply paying just some portion of ***6*** to BRC for some proportionate share of 10% royalties (i.e. under a deal stripped of all the tax and deposit frills), it seems difficult to suppose that even some portion of ***6*** was the right price to pay for a corresponding portion of 10% of the royalties. This present scheme suggests that that would have been too risky. That seems to suggest that, while we are reasonably clear that BRC would not have been prepared to do a deal on the basis of receiving a much higher up-front payment in return for losing the entire interest in the eventual success of the project and any share of royalties, it still seems that if ***6*** was an over-risky price to pay for 10% of the royalties, BRC's actual pricing seems to suggest that ***60*** would have been a very considerably excessive and over-risky price to pay for 100% of the royalties. While we have done this calculation by looking at the known facts in relation to the BRC deal, we say that this is sensible because it does at least derive some calculations from a more genuinely negotiated deal, as distinct from a hastily researched fiction.

73. As the Respondents said, the further obvious point is that even if (as we seriously doubt) the traditional research would have cost the Partnership ***100***, that does not remotely suggest that the project would have been worth that amount or that anyone would have undertaken it. While, as a matter of the relationship between cost and value, that point is obvious, the point mentioned in the previous paragraph strongly suggests that it would certainly not have been worth pursuing the project on that basis.

74. The exercise of obtaining the quotes in relation to the cost of pursuing the research by traditional methods was a wholly artificial exercise, undertaken only to buttress the tax scheme and not because that version of the project could or would have been contemplated by anybody, and the exercise proves nothing to us.

Whether it was always certain that neither the Partnership nor Numology would not directly pursue the research project, other than via the sub-sub-contractor, BRC

75. This is a question to which the answer is of course obvious, but the Respondents asked us to address it, doubtless because it is a key step in the Respondents' sham contention.

76. Beyond the fact that everyone knew that neither the Partnership nor Numology was ever intended to undertake the research project in any other manner than through the contract with BRC, and beyond the fact that Mr. Hardy conceded this, the most obvious reason why the Partnership and Numology could not have undertaken the project without BRC (beyond the fact that neither had any expertise) was that neither had the funds to pursue the project in that manner. The banking terms made it absolutely inevitable that the ***57***, the ***29*** and the ***3*** (i.e. ***89*** ignoring the obligation to pay ***5*** as fees as well) had got to be applied in various ways that made it impossible for them to be applied in scientific research.

77. It was therefore wholly fictitious to suppose that Numology might itself undertake the research project.

Whether, both in 2007 and 2014, there were reasonable prospects of the royalties being received by the Partnership

78. We fail to see any relevance to this question in relation to the estimation of success judged in 2014. Addressing it nevertheless, and noting that the Respondents' counsel criticised Mr. Williams for being *"an uncritical cheerleader whose view was not impartial but only [gave] an (unrealistic) rosy picture"*, we did get the impression that there were relatively good prospects of receiving royalties, viewed as in 2014 and 2015. It sounded as

if the FDA had treated the filings by BRC very seriously, and Mr. Segal certainly suggested that he thought that FDA approval was imminent. Whether of course the end product can be exploited commercially, and to the scale suggested by some of the predictions, remains to be seen. Mr. Segal, we repeat an impressive witness, seemed genuinely excited about current prospects. We also note that BRC and Numology share net revenues on a *pari passu* basis, and not on the "film scheme basis" whereunder the royalties only flow after numerous other prior ranking demands on profits have been met. For that reason and in view of the general present day evidence we speculate that the chances of Numology receiving debt repayments out of net revenues is now quite reasonable. We have already noted that the fairly extraordinary dealing with the right to the repayment of the Schroders loan would appear to deprive the Partnership and the partners collectively of £97 million of royalties out of the 10% share, but if and when the Schroders loan held by Numology has been repaid, the partners will then of course receive and retain any royalties that continue to flow.

79. We agree with the Respondents that eight years earlier, the prospect of success and the prospect of the Partnership receiving royalties would certainly have been far more difficult to assess, and we consider that mathematical calculations of the chance of receiving royalties or the amount of such royalties would have been based on so many unproven assumptions, that the Respondents are right to say that the prospects in 2007 would have been more like a bet.

Was the scheme a tax scheme?

80. It was not seriously disputed by Mr. Hardy, and was anyway obvious, that this scheme was a tax deferral scheme, and that it was largely sold to potential partners on that basis. The very feature, following the announced law change on 2 March 2007, that the two borrowings were inserted, entirely so far as we can see for the tax reason of deferring tax (an unpromising conclusion in the context of the potential application of section 787 Taxes Act 1988) appears to put this issue entirely beyond doubt.

Fees

81. We do not proposed to make any findings of fact in relation to the confused picture concerning the payment of the various fees. We will deal with the fees in due course.

Non-commercial features

82. The Respondents contended that there were many hopelessly uncommercial features to the various steps in the planning. Mr. Hardy effectively conceded this, though he did say that looking at matters in the round, the scheme all "came together" and made a coherent whole, and that everyone could be very pleased with the structure.

83. We will deal now with the uncommercial features.

84. It is not surprising that there were oddities and uncommercial features in this scheme, because when the main tax hope was based on an absolute fiction, namely that the Partnership had incurred capital expenditure of ***100***, ***99*** or ***96*** on scientific research, when in reality it was appreciated by all that no researchers or scientists were ever to receive contributions to their project of any more than ***6,*** this fiction would obviously occasion some unrealistic and uncommercial terms.

85. We agree with the Respondents that Numology was an artificial SPV which, whoever owned it, effectively operated at the bidding of Matrix. It had done so in the *Vaccine Research* scheme, and did so in relation to the present transactions. Mr. Segal said that

virtually all his negotiations had been with Mr. Hardy and Mr. Carlton of Matrix and that he could not remember ever having met any of the individuals in Numology. We think it a fair assumption that as an SPV, effectively created by Matrix to perform roles in tax planning schemes, the concern of Numology would have been to see that what it was doing was legal, that it would not involve losses, and hopefully that it would generate profits for the charity that apparently owned Numology. In particular we note that Numology's scientific advisers were introduced to Numology by none other than BRC. We also conclude that Numology and the Partnership had no rights of control over how BRC pursued the project, and it is quite possible that suggestions derived from scientific advisers introduced by BRC may not have been wholly based on objective analysis.

86. Ignoring the fundamental sham point, which we will deal with in our decision, the whole feature of Numology paying fixed payments, described as "fixed royalties" was extremely odd. Naturally the royalties came in no way from BRC, and were not measured in any manner by reference to anything to do with scientific research. The payment of the ***57*** was only to be made, following the 2 March 2007 announcement of the law change, to enable the partners to pre-pay interest, all funded by the initial borrowings having been correspondingly increased. Beyond those steps being wholly uncommercial, they appear to have been exceptionally risky in that if capital allowances were to be denied for any expenditure in excess of ***6***, the feature that the payment of ***57*** was expressed by the documentation to be income, and the fact that, on the basis of this Decision at least, there was very little chance of sustaining any claim for interest relief for the two total pre-payments, partners will have failed to achieve any tax deferral, and might end up being liable for tax on the ***57***, all of which will inevitably have gone straight to the two banks with no provision or deduction for any possible tax liability on the ***57.*** While these observations drift into the topic referred to as issue 10 in paragraph 32 above, and we are not going to deal with them, we consider it to be absolutely clear that all the circulating payments that we have just dealt with (including of course the ***29*** and the ***3*** paid for the assignment of the Schroders loan) had no remote relationship to scientific research or indeed to "guaranteed fixed royalties" ***derived from*** scientific research.

87. We have already made the point that the terms of the BRC option were non-commercial. Numology only had a 10% interest in the royalties, so that the feature that the floor price in relation to an exercise of BRC's call option (if exercised prior to completion of the project) was geared to the ***100,*** the ***99*** or the ***96***, was totally unrealistic. We accept that had BRC sought to buy out the Partnership's and Numology's 10% interest at a more sensible price, the Partnership and Numology might have been amenable to that. Nevertheless the reason why the floor price of the option had been pictured at the high level, when the aim was to return to the partners the realistic cost of the project, must have been that any other chosen floor price (geared for instance to the realistic cost of the scientific research) would have been inconsistent with the fictitious claim that the Partnership's relevant cost had been the high figure.

88. It was also of course odd for the remainder of fixed royalties to remain payable by Numology, were the option to have been exercised, because the payments would not then be royalties in respect of intellectual property owned by either the Partnership or Numology. Of course Numology had to continue to pay the fixed royalties, and the Partnership had to distribute them to the members who automatically had to apply the pre-tax amounts in paying down the balance of the BoS loan, but to call these payments royalties was unrealistic. This

illustrates the reality that most of the money movements related entirely to the borrowing arrangements, and had nothing to do with genuine royalties derived from scientific research.

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

90. Beyond the fact that the whole Schroders loan was totally non-commercial, the feature that the limited recourse right to the repayment of the principal was assigned (in return for money handed to Numology in the first place that was not applied in incurring expenditure on scientific research) must have been explained by one or other of the possibilities that we canvassed in paragraph 66 above. In any event, Mr. Hardy could advance no commercial reason for this assignment.

91. In all, we agree with the Respondents' contention that there were many uncommercial features to the individual transactions, virtually all designed to force the ill-fitting pieces to make something approaching a coherent whole.

Our Decision

92. We will deal now with each of the numbered challenges mounted by the Respondents in relation to this scheme in the order given in paragraph 32 above.

The sham contention

93. The first is that the scheme was a sham insofar as it was suggested by Clause 3 of the top level research agreement that Numology would undertake the study itself or procure that it be undertaken by BRC. The Respondents claimed that the first limb of that alternative requirement, namely that Numology would undertake the study itself, was false and a sham. So too of course was the hopelessly artificial top level Schedule that we referred to in paragraph 52 above that broke down the individual costings that aggregated to the top level total of either ***99*** or ***96*** between the numerous individual stages and topics in the total research programme. The Respondents claimed that it was never remotely envisaged, or even possible (for the reasons already canvassed) for Numology itself to undertake the study, and everyone knew, and the bankers' constraints in relation to all the borrowed money made it inevitable that Numology itself would not undertake the study (either for ***99*** or indeed for any other amount). Had the false wording about Numology undertaking the project itself, been deleted, such that the terms between the Partnership and Numology would have just referred to the requirement that Numology would sub-contract the research to BRC, it would have been impossible to provide that ***99*** (or indeed any other amount than ***6***) was to be paid to procure that BRC would conduct the research.

94. The Appellants' counsel claimed that it was perfectly permissible to phrase Clause 3 as involving the two alternatives. Furthermore everybody knew that Numology was to pay

BRC ***6*** so that no deceit was involved. He also provided the personal example of having contracted with a particular builder for building work himself, when he knew that in fact the whole of the work was to be sub-contracted. There was nothing wrong with that and so there was nothing wrong with clause 3.

95. The first thing to observe about the wording of clause 3 was that it was the insertion of the first limb of the alternative wording that enabled it to be contended that the full ***99*** or ***96*** had been paid to Numology for the scientific research. This was critical to the Partnership's claim for capital allowances because the essential argument was that if the whole payment had been paid to Numology to undertake the scientific research, then in accordance with two propositions drawn from the House of Lords' decision in *BMBF v. Mawson* [2005] STC1 and the Supreme Court decision in *HMRC v. Tower MCashback* [2011]UKSC 19, capital allowances would be available for the full expenditure of ***99*** or ***96.*** The argument was that if the full expenditure in the contract between the Partnership and Numology was expressed to be incurred on scientific research, then allowances would be available provided that two conditions were satisfied. One, based on *Tower MCashback*, was that the price paid had to represent fair value, or at least there had not to be a material over-payment for the expenditure. This is why all the attention was given to the quotes from the "traditional" research institutions. The other proposition, not so much a condition but a feature that one could ignore in considering whether allowances were available, was the *Mawson* point that once the capital expenditure had been incurred, one could ignore all the accompanying money movements. One concentrated just on the feature of technically incurring the capital expenditure at the appropriate level.

96. We will deal with those two points in relation to *Mawson* and *Tower MCashback* when dealing with the second basis of challenge. In relation to the Respondents' sham contention, we agree that there was a sham in this case not remotely because any of the parties or indeed the investing partners were intended to be deceived into thinking that the possible aim of sub-contracting to BRC was just one of two realistic possibilities. Of course it was known that it was the only conceivable way of proceeding, and that the alternative contractual provision suggesting that Numology might itself conduct the research was false. The significance of the false claim was that, had it been deleted in accordance with reality, such that Numology's obligation to the Partnership would have been to sub-contract the research to BRC, it could not possibly have been suggested that Numology was ever to pay more than ***6***, let alone ***99*** or ***96***, to BRC in order to procure the scientific research. The falsely worded clause 3 was therefore the foundation of the Partnership's claim for vastly excessive capital allowances, and this is why we decide to strike it down as being a sham. The Respondents' counsel was slightly more hesitant in describing the whole pricing of the scientific research in the Schedule to the top-level contract, sub-dividing the total expenditure and allocating elements of it to each step and stage in the research, as a sham. We are not so hesitant. By sub-dividing the alleged expenditure of ***99*** or ***96*** in this way, inserting all this elaborate nonsense into the Schedule, it becomes clear that the critical drafting of clause 3 is not just some mistaken reference to one irrelevant possibility. The Schedule shines the light on the fact that the whole fiction is indeed intended, and that it is indeed the foundation of the Partnership's claim.

97. We are not persuaded by the points made on behalf of the Partnership that we mentioned in paragraph 94 above. We have already dealt with the irrelevance of the point that none of the actual parties were intended to be deceived. As to the personal example advanced by the Appellants' counsel, we note that in his example there was no suggestion of

one possibility being real and the other a sham. And there could have been, indeed there probably was, reality to the feature of contracting with the initial builder even though it was appreciated that all the work would be sub-contracted. For the significance of the initial builder's obligation is that he doubtless had control over the selection of suitable sub-contractors and he would also have had some responsibility for the project being conducted to the required standard. So the role of the principal builder, and the contractual liability that that builder assumed, would not remotely have been a sham.

98. In passing, we consider that it is possible that there was another quite different element of sham in this case. We have yet to deal with all the complication and the conflicting explanations as to how various fees were paid. The point that we now make is merely one of many grounds on which we conclude that all the fees were non-deductible. However, it appeared to be suggested at one stage that the Partnership paid a fee to Matrix for services of some sort, and that this fee was either wholly or partly applied in paying the loan arrangement fees to the two banks on behalf of the partners. It was claimed by the Appellants that the deductibility of fees was to be governed by what the contract said that the fees were for, and that it was immaterial to consider what the recipient did with the consideration paid for the services.

99. We do not accept that. If the Partnership paid the partners' fees for raising finance to contribute to the partnership, or paid Matrix a fee to procure that Matrix paid those fees, the fees are non-deductible. If the fee is miss-described so as to appear to be a fee for some trading service that would ordinarily have been tax deductible, the fee should obviously still be disallowed. Nobody would expect that fictitious label to enable the payer to secure a trading deduction.

100. This point may or may not be material in this case and we do not know enough about the facts. Furthermore as repeatedly stated, we will deal with the fees on various bases that will render this particular issue irrelevant. We nevertheless put down the marker that it is possible that there was also some element of sham in relation to these fees.

The quantum issue

101. The second contention by the Respondents was that, aside from the sham contention, the claim for capital allowances should be limited to the ***6***, that amount itself being dependent of course on the later issue of whether we decide that the Partnership was trading.

102. The First-tier Tribunal decided this issue in the *Vaccine Research* case, on this quantum argument in favour of the Respondents, and that was upheld by the Upper Tribunal.

103. We quoted the relevant statutory provision at item 2 in paragraph 32 above, the question simply being *"In what amount has the partnership incurred capital expenditure on scientific research?"* That provision should be construed purposively, and the facts should be analysed realistically.

104. Assuming that our decision on the sham issue is wrong, the starting point to this present enquiry is that the Partnership paid Numology ***99*** or ***96*** for the scientific research. Applying the two principles purportedly based on *Mawson* and *TowerMCashback*, it was then said by the Appellants that the right price was paid for the scientific research (a dubious proposition so far as the facts were concerned) and that it was appropriate to disregard all the money movements. You simply pay regard, under *Mawson,* to what the lessor paid on incurring the capital expenditure, or in this case you simply focus on the single fact that the

Partnership had paid Numology the high price for the scientific research, and you ignored all the money movements.

105. We consider that both the propositions allegedly drawn from *Mawson* and *Tower MCashback,* i.e. those mentioned in paragraph 95 above and again in paragraph 104, are wrong.

106. We consider that the fundamental point to emerge from *Mawson* was that under the then statutory provisions, if a lessor incurred realistic expenditure on purchasing an asset that was to be leased, allowances would be available regardless of whether the lessor was realistically providing funding to the lessee. Where the lease was funded, for instance, by deposits placed directly or indirectly with the lessor by the lessee, the reality was of course that the lessee was not deriving financing by entering into the finance lease. It would in economic reality simply have been selling its capital allowances to the lessor bank group for a fee consisting of the reduction in lease rentals as against the profile that would have prevailed, absent the lessor's cash flow benefit of obtaining the capital allowances. In *Mawson,* that was all that the various money movements were all about. The pipeline (insofar as it was possible to value it) was plainly worth the price paid. None of the deposits were fictitious soft loans, never to be discharged and designed to ramp up the price paid for the pipeline. It was easy to see HMRC's objection to the type of arrangement in *Mawson* because, in a rather more involved way, the lessee group was simply selling its cash flow saving inherent in the capital allowance legislation to the lessor group that could use it against its profits, and the economic end result was not that different from a fake grouping scheme, where allowances had been shifted from one group to a quite different group, via artificial shareholdings. Whether that was the reality, the decision in *Mawson* was simply that the claimant of the allowances was simply required to show that it had incurred capital expenditure and, if it had done that, then under the then law it secured the allowances.

107. The point to be derived from *Tower MCashback* is not, as was suggested by the Appellant, that the allowances are available provided that the right price has been paid for the asset, or in this case the scientific research. Nor indeed is it right to say that a taxpayer cannot have allowances for a price that exceeds the value of a purchased asset. The statutory requirement looks simply to the incurring of the expenditure, and not to what the asset is worth, and if, for instance, an ignorant trader buys a capital asset for £110, when the asset is regularly available from many sources at a published brochure price of £100, of course the ignorant trader secures allowances for the £110. The point that emerges from *Tower MCashback* is that if the price paid for the asset, or for scientific research in this case, is significantly in excess of the value of the asset, then one is involved in a serious enquiry as to what exactly is going on, and once that is the case, addressing the money movements can be highly relevant. You can ignore the money movements if they simply impact on the realistic funding of the lessor in incurring the expenditure and in no way affect the realistic price paid and the quantum of capital expenditure incurred. . You cannot ignore them if they constitute soft loans that are likely never to have to be repaid, all designed to ramp up the price of the capital expenditure ostensibly incurred, to a wholly unrealistic figure.

108. In the present case, applying the statutory provision quoted in paragraph 32 above purposively, and analysing the facts realistically, it is absolutely impossible to conclude that capital expenditure has been incurred on any scientific research in any amount in excess of ***6***. Once one addresses all the money movements, it immediately emerges that they reveal that there has been no reality to the claim that capital expenditure of ***99*** or ***96*** has realistically been incurred on scientific research. Indeed had everybody involved with this scheme been

asked what amount would have been expended or disbursed that would result in scientists or researchers working away seeking to pursue scientific research, inevitably everybody's answer would have been ***6*** **.** We actually find it difficult to see how it was ever envisaged that the claim for allowances in the higher amount could possibly have been sustained.

109. The reality is that the allowances were due (assuming at this stage that the Partnership was trading) for no more than ***6***.

Whether the Partnership's entire activity was a trading activity

110. The First-tier Tribunal's decision in *Vaccine Research* was that the entire activity did not involve trading, but that the element geared to the sub-contracting did.

111. The implications of this present point and the next (as to whether the sub-contracting activity at least was a trading activity assuming that the entire activity was not a trading activity) of course differ. A decision in favour of the Respondents in relation to this first issue (i.e. the financial transactions with the sub-contracting aspect potentially remaining a trading activity) would not necessarily undermine the claim for capital allowances in respect of the ***6***, while a decision in favour of the Respondents in relation to the next issue would undermine the claim for all allowances. In the light of the First-tier Tribunal's decision in relation to fees, and the feature that the Upper Tribunal confirmed the First-tier Decision in this regard, a decision in favour of the Appellants in relation just to the next issue would still leave all the fees being held to be non-deductible. On the basis that they would be funding mixed trading and non-trading activities, and that the Upper Tribunal precluded a sub-division of the fees, they would all be non-deductible. It also appears to us that a decision against the Partnership on this present issue, even if there were a decision in favour of the Partnership on the next issue, would have a bearing on the "wholly applied" requirement of section 362 Taxes Act 1988. Our decision on section 362 is however against the Appellant on other grounds anyway.

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

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

the receipt of the fixed royalties. The disbursement of the ***3*** by Numology, applied by Numology in purchasing the limited recourse right to the repayment of the Schroders debt, generates no conceivable return to the Partnership. All that it may do, assuming receipts of fluctuating royalties, is pass to Numology up to £53.4 million in debt repayment, at a loss to the partners, in terms of pre-tax flow of fluctuating royalties, of potentially about £97 million.

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

Whether the Partnership is trading in relation to the limited activity in relation to the sub-contract of the genuine scientific research to BRC

115. Our decision is that no part of the Partnership's activity is a trading activity. In this respect our decision differs from that reached by the First-tier Tribunal in *Vaccine Research*, but we do not consider that the feature that the Upper Tribunal treated the earlier decision as tenable necessarily means that our present decision to the other effect is wrong.

116. The reasons why we consider that the element of the Partnership's activity in relation to the sub-sub-contract in which research was undertaken by BRC is not a trading activity are as follows.

117. We are influenced by the marketing and the reality of this scheme which was that it was first and foremost a tax deferral scheme, coupled with secured receipts effectively just to pay off borrowings, and those two features were treated as the basis on which intending partners could sensibly join the Partnership, with the possible receipt of fluctuating rentals being a possible "add-on". Without them, however, the scheme was marketed on the basis that it was thought that everything made sense even if there were no receipts of fluctuating royalties.

118. The next point is that, although the intellectual property is technically licensed to Numology and then the Partnership and then immediately licensed back to Numology and then to BRC, the substance is that an up-front payment is made for possible receipts of net royalties. The Partnership will in no way incur further costs in any trading venture. Many of the fees charged appear to be structuring fees, and certainly not fees that represent on-going expenses of a trade. Furthermore there is no active involvement that might occasion trading losses. There has simply been an up-front payment for a possible revenue stream and that does not appear to us to be a trading activity.

119. We largely accept the Respondents' claim that at the outset the prospects of there being fluctuating royalties was highly speculative, and akin to a bet. This was not only the view of BRC in November 2007 when the document from which we quoted in paragraph 58 was issued, but this view tallies with the point made above in paragraph 117. This militates against the activity being a trading activity.

120. Neither the Partnership nor Numology had any right of control over how BRC undertook its research project. The absence of any right of control is again a pointer against the trading analysis.

121. The fact that a scheme may be a tax scheme may of itself have nothing to do with whether a participant in the scheme is trading, but when the efficacy of the tax scheme has resulted in the insertion of wholly non-commercial arrangements into the steps that might be trading transactions, this also militates against the trading analysis. We have already explained why we consider that the floor price in relation to the option, the feature that all the payments made by the Partnership to Numology are "non-refundable in all situations", and the way in which the payment of the ***3*** by Numology to Schroders appears potentially to deprive the Partnership of about £97 million of pre-tax royalties are all inexplicable on trading grounds. This is significant. It does not matter that the floor price in relation to the option, if exercised prior to completion of the project, is in favour of the partnership. The point is that the floor price is pitched at a ridiculous level for some ground that has certainly nothing to do with any serious trading considerations.

122. Our conclusion is that the Partnership is not trading at all.

Whether, if we are wrong in relation to our decisions in relation to either of the two previous points, loss relief is curtailed by section 384 Taxes Act 1988

123. The Respondents did not advance this particular point with much vigour, and on the basis that either of our decisions in relation to the two preceding points is held to be wrong (such that this point becomes material) we consider that the Respondents' contention is wrong. We were basically impressed with the witnesses who spoke for BRC, and when therefore it seems that if the Partnership's activity, at least in relation to the sub-contracting activity, was conducted in the most promising and potentially profitable manner that appeared to be available, we cannot say that the trade, once it is assumed that there was a trade in relation to the sub-contracting, has been conducted un-commercially. It may have been conducted passively, and without much attention to prospects at the outset, but once those factors have been set aside, as we must assume on the basis of the present assumption that the sub-contracting activity involved trading, it was conducted in the best possible manner, and in other words, wholly commercially.

Whether the payment of interest on the Schroders and BoS loans was allowable under section 362 Taxes Act

124. Repeating the quotation from section 362 Taxes Act mentioned in paragraph 32 above, the first question that we must answer in relation to the deductibility of the interest on the Schroders and BoS loans (respectively of the ***43*** and the ***43***) is whether the monies borrowed to contribute money to the partnership as capital *"[were] used wholly for the purposes of the trade"* conducted by the Partnership.

125. On the basis of our decision in relation to the trading issues in the two sections of this Decision above, the interest paid on both the Schroders and the BoS borrowings cannot qualify for relief since none of it can have been used for trading purposes.

The borrowing from Schroders

126. On the basis that our decisions in relation to both trading issues were wrong, we still conclude that the interest on the Schroders loan was non-deductible, because when the monies borrowed were at all times in blocked accounts, it is both permissible and appropriate to trace the application of the monies in question. While the ***43*** had been paid to Numology, ***40*** of that had immediately been paid back to the Partnership and the partners and automatically applied in pre-paying the interest on the Schroders loan. The remaining ***3*** had also been paid to Schroders by Numology to procure the assignment to Numology of the

limited recourse right to receive the repayment of the principal. Accordingly none of the identified monies, held in Schroders blocked accounts, was actually available to the Partnership or indeed Numology for any trading purpose, or in reality for any purpose of the Partnership whatsoever. Even if the Appellant's primary contention was upheld, either because the sham contention was over-ridden on appeal, or because for some other reason the Partnership's entire activity was treated as a trading activity (presumably on the basis that the Partnership's entire capital had been applied in scientific research, and thus for trading purposes), we would still reach the same conclusion in relation to the interest on the Schroders loan. When, immediately after the contribution, the entire money borrowed from Schroders has disappeared from the Partnership's asset base, it remains impossible to say that the Schroders money has been applied for any trading or indeed any non-trading activity of the Partnership.

127. The reality of the Schroders loan was of course that it was only borrowed in order to facilitate the pre-payment of interest, so that when in reality none of the money borrowed was available to the Partnership for any purpose, it is hardly surprising that the interest cannot qualify for relief under section 362.

The borrowing of 43 from BoS

128. The same applies to the BoS loan in that the disbursement (again out of blocked accounts with BoS) of the ***17*** (i.e. the ***17*** out of the ***57*** that was not paid to Schroders to pre-pay the interest on the Schroders loan) and the ***29*** were not trading transactions. Accordingly again, none of the BoS money can be said to have been used *"wholly for the purposes of [any] trade of the Partnership."* This conclusion would certainly be doubly justified if the Partnership was conducting no trade at all. If we were wholly wrong in relation to the trading issue, however, and it was held on appeal that the Partnership's activity was entirely a trading activity, including the see-through manner in which Numology has to apply the ***29*** inevitably to fund the residue of the fixed royalties and the repayment of the BoS borrowing made by the partners (in our view an extremely improbable analysis) we still decide that the payment of the ***17***, paid indirectly out of the borrowed money, would undermine the *"wholly"* element of the section 362 requirement that the borrowed money be applied *"wholly for trading purposes"*. We would be content to treat an ordinary annual payment of interest, paid in respect of a trading borrowing, as not prejudicing the proposition that money may have been borrowed wholly for trading purposes, but when there is a massive prepayment of fixed royalties followed by a total pre-payment of all the interest on a 15-year loan, and when the loan is drawn down entirely to occasion that artificial *"borrowing and pre-payment"*, we do consider that those related steps, culminating in the pre-payment of the entirety of the interest, would have undermined the *"wholly"* requirement.

129. The Appellant's counsel had contended that we should ignore the way in which we have actually traced the application of the Schroders and BoS borrowings, by following the required flow of funds between the blocked accounts. He said that it was unrealistic, and that it could not possibly be right in the case of a partnership that conducted both a trading and a non-trading activity, that partners might secure tax relief for interest by somehow earmarking monies borrowed, and by ensuring that they were applied in the Partnership to fund the trading purpose. He suggested that such tracing should be ignored, in both the example just mentioned and on the facts of this case, and that the borrowing should be apportioned between the different activities, and interest relief granted for the proportion allocated to the trading purpose.

130. Our first observation in relation to that suggestion is that it then becomes very far from clear how to apply the section 362 requirement to the effect that the borrowed money must be applied *"wholly"* for trading purposes.

131. More relevantly in this case, however, the earmarking is not based on some slightly artificial allocation made by the partners of the Partnership, but derives from the insistence of both banks that at all times, while the borrowed monies go into and come out of the structure in order to achieve the hoped for accelerated tax relief on the pre-payment of interest, absolutely nothing can undermine the banks' interest in seeing that their monies go in and out, exactly as intended and required.

132. We thus reject the Appellants' contentions in this regard.

Whether the payment of interest on the Schroders loan failed to rank as interest at all pursuant to the Court of Appeal decision in Cairns v. MacDiarmid

134. The facts of this case are materially different from those in *Cairns v. MacDiarmid.* Some versions of the early 1970s pre-payment of interest schemes culminated in a discounted payment from the borrower to the lender for the immediate discharge of the loan, whereas in *Cairns v. MacDiarmid*, the Rossminster version of the scheme involved the borrower paying a company related to the lender to assume the borrower's liability under the loan. At least then the loan remained owing, albeit no longer by the borrower.

135. In the present case, however, following the pre-payment of the whole of the interest on the Schroders loan, the individual partners not only retained the limited recourse liability to repay their borrowings, but they face the prospect that if fluctuating royalties do eventually flow, the first £97 million of pre-tax royalties are likely to be applied in both paying the tax on the royalties and then repaying the Schroders loan. The consequence of this is that there does remain very significant reality to the partners' liability on the Schroders loan, and we are unable to treat the interest payment as a wholly fictitious payment in the manner that the Court of Appeal did in *Cairns v. Macdiarmid.*

136. No issue in relation to *Cairns v. Macdiarmid* arises in relation to the BoS borrowing.

Whether interest relief for the interest on both borrowings is denied by section 787 Taxes Act.

137. Section 787 Taxes Act 1988 provides that:

> *"Relief shall not be given to any person under any provision of the Tax Acts in respect of any payment of interest if a scheme has been effected or arrangements have been made (whether before or after the time when the payments were made) such that the sole or main benefit that might be expected to accrue to that person from the transaction under which the interest is paid was the obtaining of a reduction in tax liability by means of any such relief."*

138. The Appellants' counsel claimed that section 787 was a provision of very narrow scope. He also contended, in reliance on Judge Berner's decision in *Garrett Paul Curran v. HMRC* UKFTT 517 (TC), a decision that we were told that HMRC were not going to seek to overturn on appeal, that the right approach was that we should put onto scales the tax benefit on one side of the scales and the other benefits on the other side, and see which were the greater benefits. Only if the tax benefits outweighed any other benefits would section 787 then disallow the interest.

139. While the section addresses *"the sole or main benefit that might be expected to accrue"*, and it does not address the taxpayer's main purpose, we consider it worth addressing the *"scheme"* notion implicit in the section by noting that between 2 March 2007 and 2 April 2007, the steps in the present scheme were materially changed. The reason they were changed was entirely to seek to circumvent the £25,000 limit for offset of losses against other income implicit in the original version of the scheme, by ramping up the borrowings, procuring a massive (and somewhat unrealistic) early payment of fixed royalties *(i.e. the* **57**) which was entirely to be applied in pre-paying interest. One scheme for maximising the claim for capital allowances was thus to be blended with another scheme, for pre-paying interest. There was therefore clearly a *"scheme"*.

140. Addressing now the perceived benefits derived from the Schroders borrowing, it appears that the hoped for tax benefit is on one side of the scales, and that effectively nothing is on the other side of the scales. Indeed on one analysis, the other side of the scales may contain nothing but unpalatable disadvantages. The first point to address is that, of the ***100*** that the partners put into the partnership, ***57*** goes in and comes out, which is neutral. Looking just at the Schroders component of that, ***43*** goes in and ***40*** comes out. It is in fact far from neutral if the receipt of ***57*** as taxed royalties is not sheltered from tax by the claim for capital allowances, or on some other ground. But even assuming for the purpose of this exercise that the receipt of the ***57*** is tax free, the money has simply moved into and out of the Partnership which is neutral. The partners cannot then look to some other investment return, or return of capital by the Partnership because the only possible source of profit return consists in the possibility of receiving fluctuating royalties, and the right to those royalties resulted from the payment of the ***6*** and certainly cannot have derived in any way from the Schroders borrowing. We accept that ***3*** of the Schroders borrowing has not been returned to the partners, but the ***3*** has been left with Numology to enable Numology immediately to purchase the assignment of the repayment rights in respect of the Schroders loan. That can certainly confer no benefit on the Partnership or the partners, and indeed its only implication is that if fluctuating royalties are received (those royalties clearly not being any sort of return that derives in any way from the Schroders borrowing) the first £97 million will only flow to the partners in the sense that the post-tax amount will be applied in repaying the Schroders loan to Numology.

141. The summary of the attributes (benefits and detriments) of the Schroders borrowing, and the scheme for accelerating tax relief is that there was a hope of obtaining early relief for interest, but at the very best that had to be set against the feature that the ***43*** had gone into the Partnership, ***40*** had come back (that being therefore neutral assuming that there was no tax liability on the ***40*** element), and the ***3*** had disappeared in the direction of Numology, presumably to enhance the chances of dis-applying *Cairns v. MacDiarmid.* Viewing the consequences of the interest pre-payment scheme in the light of this Decision, the implications appear to be that, whilst for two reasons (s.362 and s.787) no relief will be available for the pre-paid interest, the supposed benefit of the pre-payment of interest will generate no net investment return of any sort. It may result in the return to the Partnership and the partners of the ***40*** element of the ***57*** being taxable income of the partners, when the funds have of course been entirely applied, without provision for tax, in making payments to the banks. It can occasion no other investment return of any sort, and the sole consequence of the dealing with the ***3*** seems to be that the partners have had to give up the pre-tax receipt of £97 million of fluctuating royalties to an SPV owned by a charity for no obvious commercial reason, and perhaps simply to protect against the application of *Cairns v. Macdiarmid.*

142. A very similar analysis arises in relation to the BoS borrowing and the application of section 787 Taxes Act 1988. In relation to the pre-payment of the whole of the interest, the implications are the same as that feature of the steps in relation to the Schroders borrowing. In other words, if the Partnership and the partners somehow manage to escape tax on putting ***17*** of the BoS borrowing into the Partnership as capital and immediately retrieving it in the form of royalties, then the partners are neutral. If they are taxed on the recovery of the ***17***, they thereby suffer a very considerable disadvantage. Exactly the same points then apply to the ***29***. The deposit acquired with the ***29*** is designed to accrue income over time, and eventually to fund fixed royalties of ***43*** that we understand are automatically to be applied (in their entirety) in repaying the principal of the BoS loan. The partners suffer a massive disadvantage if the periodic fixed royalties remain taxable (on account of the absence of capital allowances) because they then have to fund the tax on those royalties from other funds. No further distributions of any sort that can be said to derive in any way from the BoS borrowing can come from the Partnership. The entire funds therefore that will flow from the Partnership will simply result in the repayment of the BoS borrowing, and the partners and the Partnership will suffer again an unpalatable disadvantage if the royalties suffer tax.

143. Our conclusion is that section 787 Taxes Act results in the disallowance of the interest on both borrowings.

The fees and expenses

144. We said that we would deal with this topic in an inadequate manner, though if certain of our conclusions are not overturned on appeal, our failings will be irrelevant.

145. Our understanding by the end of the hearing was that it was still not entirely clear how and by whom various expenses had been borne. There was certainly an element in which one party (when liable to pay another some particular amount) will have ***directly*** paid a reduced amount, but will then correspondingly have paid on behalf of the recipient some fees that the recipient was liable to pay. In this situation, the right approach is to treat the payer as having discharged its full liability to the payee, with the payee then being treated as having borne the expenses that it was technically liable to pay. Whilst that seems clear enough, all the figures were extremely confused and it was both counsel, rather just we as the members of the Tribunal, who appeared to remain unclear as to how the various fees had all been dealt with.

146. The following principles appear relatively obvious, however, and since they result in all the fees being disallowed unless various of our decisions are overturned on appeal, it may be sufficient simply to reach a decision in principle on the following matters.

147. Insofar as more was paid to Numology, with Numology then being directly liable itself for various fees, as we mentioned in paragraph 22 above, then the Partnership would be making its claim for tax relief simply by increasing the amount ostensibly given to Numology for scientific research. Unless therefore all of our first four decisions are overturned on appeal, no tax relief will be available to the Partnership for these augmented payments.

148. Insofar as fees were phrased to be payable, under the contract for their payment, for general trading purposes, we consider that the fees would be disallowed were it the case that the fees simply funded loan arrangement fees chargeable on the individual partners in respect of the two borrowings. The contract would simply have miss-described what the fees were for, and their deductibility should be dictated by the reality of the situation.

149. Many of the fees appear to have related to creating the structure of the transaction, and we consider that they would rank as capital and should not be allowable.

150. The fundamental point, of course, is that unless both our decisions in relation to the trading issues are overturned on appeal, then it follows that no expenses can be allowed as trading expenses. The Upper Tribunal upheld the total disallowance of fees in the *Vaccine Research* case where indivisible fees had been paid partly for trading and partly for non-trading purposes. The First-tier Tribunal had held that the sub-contracting activity in *Vaccine Research* had been a trading activity whilst no other activity had been a trading activity, and on the basis that indivisible fees for services in relation to both limbs of activity could not be split, all the fees thus failed the *"wholly and exclusively"* test.

151. On the reasoning, therefore, that for one reason or another none of the fees was deductible for tax purposes, it may be that our failure (possibly everybody's failure) fully to understand the detail in relation to the payment of fees may be irrelevant.

Costs

152. We were told by the Respondents' counsel that for no very obvious reason the Partnership's appeal had been classified as a complex appeal, whilst Mr. Hockin's appeal had not been so classified. We were also told that the Partnership had not opted out of the costs regime in relation to its "complex" appeal. The Respondents therefore applied for their costs in respect of the Partnership's appeal.

153. We accordingly grant the Respondents their costs in relation to the Partnership's Appeal on the standard basis, any failure between the parties to agree the costs to be referred to the costs judge of the senior courts' Costs Office.

Right of Appeal

154. This document contains certain findings of fact and the reasons for the decision in relation to the matter considered in paragraph 12 above, though all other matters are the subject of the adjournment. . Any party dissatisfied with the decision given in paragraph 12 above has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) Tax Chamber Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

HOWARD M. NOWLAN
TRIBUNAL JUDGE

RELEASE DATE: 2 July 2015