[2014] UKUT 0389 (TCC)

Capital allowances – expenditure on research and development – whether partnership trading – quantum of expenditure incurred on research and development – whether trade conducted on a commercial basis – location of partnership's trade – income tax relief for interest incurred on borrowings to fund partnership capital – deductibility of fee incurred by partnership in consideration for services – whether wholly and ordinarily incurred for the purpose of the partnership's trade

BEFORE THE UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER) **FTC/40/41 and 55/2013**

B E T W E E N :

THE VACCINE RESEARCH LIMITED PARTNERSHIP
(the "Partnership")

First Appellant

PATRICK LIONEL VAUGHAN
("Mr Vaughan")

Second Appellant

-and-

THE COMMISSIONERS FOR HM REVENUE AND CUSTOMS
("HMRC")

Respondents

-and-

HMRC

Appellants

-and-

The Partnership

First Respondent

Mr Vaughan

Second Respondent

TRIBUNAL: The Hon Mr Justice Sales and Judge Julian Ghosh QC
Sitting in public at Rolls Building, Royal Courts of Justice, Fetter Lane, London EC4A 1NL on 19, 20 and 21 May

Jonathan Peacock QC and Jolyon Maugham (instructed by Berwin Leighton Paisner) for the **Appellants**
Kevin Prosser QC and David Yates, and Zizhen Yang (instructed by the **General Counsel and Solicitor to HM Revenue and Customs**) for the **Respondents**

IN THE UPPER TRIBUNAL
(TAX AND CHANCERY CHAMBER)

THE PARTNERS OF THE VACCINE RESEARCH LIMITED PARTNERSHIP and LIONEL PATRICK VAUGHAN — **Appellants**

- and -

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

JUDGMENT

Introduction

1. There are two Appellants in this case. The first Appellant is the Vaccine Research Limited Partnership ("the Partnership"). The second Appellant is Mr Lionel Patrick Vaughan. Mr Vaughan is one of the partners in the Partnership.

2. The Partnership's appeal concerns the question whether the Partnership incurred "qualifying expenditure" within the meaning of section 437 of the Capital Allowances Act 2001 ("CAA 2001"), being expenditure "on" research and development which related to the Partnership's trade. This question raises the following issues:

   (1) whether the Partnership was trading at all ("the trade issue");

   (2) if the Partnership was indeed trading, what was the quantum of the Partnership's "qualifying expenditure" ("the quantum issue").

3. So far as Mr Vaughan's appeal is concerned, a proportion (calculated by reference to the interest of the partner in the Partnership) of any "qualifying expenditure" incurred by the Partnership, to the extent that such qualifying expenditure gives rise to a trading loss for the Partnership, may be claimed as a loss against a partner's otherwise taxable income ("sideways loss relief": we discuss the relevant provisions below). To that extent, Mr Vaughan's appeal depends on the resolution of the trade issue and the expenditure issue. However, Mr Vaughan's sideways loss relief also depends on:

   (1) the Partnership's trade, if any, having been carried on on a commercial basis ("the commercial basis issue") and

   (2) the Partnership's trade, if any, having been carried on at least partly within the United Kingdom ("the trade location issue").

4. This case also raises two further issues which are conceptually distinct from that of the Partnership's "qualifying expenditure" and any loss relief available to Mr Vaughan in relation to such "qualifying expenditure". The first of these further issues is whether interest payable on certain borrowings taken out by the partners, including Mr Vaughan, for investment into the Partnership was eligible for income tax relief ("the interest relief issue"). The second further issue is whether a fee paid by the Partnership, in consideration of certain services provided to the Partnership, was deductible from its trading profits ("the fee deductibility issue").

5. Mr Peacock QC presented the argument for the Partnership and Mr Vaughan. Mr Prosser QC presented the argument for Her Majesty's Commissioners of Revenue and

Customs ("HMRC"), with Mr Yates making submissions for HMRC on the trade location issue.

6. Before the First-Tier Tribunal ("FTT"), HMRC succeeded on the quantum issue (on which the Partnership and Mr Vaughan appeal); Mr Vaughan succeeded only partially on the interest relief issue (he appeals on this issue); HMRC succeeded on the fee deductibility issue (on which the Partnership appeals); the Partnership and Mr Vaughan succeeded on the trade issue (HMRC cross-appeal on this issue); and Mr Vaughan had succeeded on the commercial basis issue and the trade location issue (HMRC cross-appeal on these issues).

7. In our view, the substance of all of the appeals and cross-appeals in this case is complaints on findings of fact made by the First-Tier Tribunal ("the FTT"). Findings of fact made by a fact-finding tribunal may, of course, only be disturbed if such findings are perverse or founded on a misdirection, on familiar *Edwards v Bairstow* grounds: [1956] AC 14. Although, as we explain below, the FTT could perhaps have set out the basis for each of its findings of fact in a more clear and coherent manner than it did, we nonetheless conclude upon due examination that each finding of fact the FTT made is sustainable and lawful. We accordingly dismiss all of the appeals and cross-appeals in this case.

The Disputed Financing Structure: The FTT's Findings of Fact

8. All of the issues concern the particular financing structure of which the Partnership formed an integral part. The financing structure and the issues raised in this appeal only make sense when set in the context of the FTT's findings of fact. The FTT's

findings of fact are not all to be found in a particular section of the FTT's decision and certain of the FTT's findings of fact are to be found in an Annex to the decision ("Annex B"). We set out the important findings of fact made by the FTT in order to put the financing structure and the various issues in context. We refer to specific paragraphs of the FTT decision in the form "FTT, paragraph [ ]."

9. The disputed financing structure arose from the funding needs of a biotechnological company, PepTcell Limited (now trading under the name of SEEK).

10. PepTcell Limited wished to secure working capital to finance research, development and various patent application costs in respect of proposed research into the identification and development of vaccines. The founder of the company, Greg Stoloff, drew on his own previous experience of finance to secure the capital his company needed by arranging a funding scheme that reduced the level of risk to investors (FTT, paragraphs [5] and [42]).

11. It is common ground that PepTcell Limited undertook relevant research and development activities for the purposes of the allowances and losses claimed (FTT, paragraph [17]). However, HMRC dispute the nature and tax effects of the commercial structure put in place to fund that research (FTT, paragraph [17]).

12. The FTT described the financing structure as "the Scheme" (FTT, paragraph [5]).

13. The FTT found the Scheme to consist of a "*series of interlocking deeds, agreements and arrangements mostly made between 15 August and 17 August 2006*" (FTT, paragraph [20]). The main elements of the Scheme were:

(1) a limited partnership agreement entered into by MRD Limited (a limited liability company registered in Jersey) as general partner and Numology Limited (a special purpose vehicle set up for the purpose of the Scheme, resident in Jersey) as the Class A Limited Partner on 15 August 2006. This established the Partnership. The Class B Limited Partners (of which Mr Vaughan was one) became parties to this agreement by adherence agreements made on the same day. They were required to pay their capital contributions on 17 August 2006. This was done as to 75 per cent (or 80 per cent of the sum to be invested after deduction of fees) by drawdown of loan facilities arranged by each Class B Limited Partner with the Bank of Scotland plc ("BOS"), on fully commercial terms, with the balance being provided by the Class B Limited Partners by other means (which sometimes included further loans from BOS);

(2) the Partnership reached agreement on 15 August 2006 with Matrix Structured Finance LLP ("MSF"), one of the entities "responsible for helping to develop the Scheme and marketing it to individual investors" (FTT, paragraph [19]), for MSF to provide agreed services to the Partnership;

(3) the Partnership entered into a written Research Agreement with Numology Limited on 17 August 2006 ("the Research Agreement"), under which Numology Limited agreed to undertake research and development, or to arrange for it to be undertaken, for the Partnership;

(4) Numology Limited entered into a written Research Sub-Contract with PepTcell Limited on the same day, 17 August 2006 ("the Research Sub-Contract"), to undertake research and development of vaccines, with any intellectual property developed being vested in the Partnership. On the same day, PepTcell Limited assigned the benefit of four identified patent applications and inventions to Numology Limited in pursuance of that agreement;

(5) also on the same day, 17 August 2006, Numology Limited assigned to the Partnership by deed the benefit of the same identified patent applications and inventions as had been assigned to Numology Limited that day by PepTcell Limited;

(6) also on the same day, the Partnership and Numology Limited concluded a licence agreement ("the Licence Agreement") under which the Partnership granted licences to Numology Limited for up to 70 years to use or deal with any products incorporating or based on any of the patents or other intellectual property arising from the vaccine research. In consideration, Numology Limited agreed to pay guaranteed non-refundable licence fees to the Partnership consisting of 15 specific sums to be paid annually in respect of the following 15 years. It also agreed to pay royalties of 10 per cent of any sums received by it or by its sub-contractors from the intellectual property. Numology Limited agreed to guarantee the licence fees by delivering a letter of credit in agreed form to the Partnership. A letter of credit in that form was provided by the Royal Bank of Scotland plc ("RBS") and delivered that day.

Further, again on the same day, an agreement and deed between the Partnership, Numology Limited and PepTcell Limited assigned the benefit and burden of the Licence Agreement between the Partnership and Numology Limited to PepTcell Limited, save for the obligation to pay the guaranteed licence fees;

(7) on the same day, the Partnership and Numology Limited also entered into an option agreement allowing Numology Limited an exclusive option to purchase any rights in any intellectual property arising from the vaccine research;

(8) by a separate series of agreements made on the same day, MRD Limited (acting on behalf of the Partnership) assigned to BOS the right to receive the guaranteed licence fees payable by Numology Limited. MRD Limited notified this to Numology Limited by an agreement to which BOS was also party and under which Numology Limited was given an irrevocable instruction to pay the licence fees direct to BOS. MRD Limited separately confirmed to BOS that it remained the beneficiary of powers of attorney given by each of the Class B Limited Partners to MRD Limited in the facility letters to each partner in respect of the loans being made to those partners by BOS. MRD Limited also made a deed that day with the Partnership and BOS creating a charge over the assets of the Partnership, including the licence fees and the licence fee security (the letter of credit from RBS), in favour of BOS.

14. The effect of these arrangements was that the Partnership received the benefit of certain patent applications and inventions (assigned by Numology Limited, which had

taken a prior assignment from PepTcell Limited in establishing the Scheme), in respect of which the Partnership paid a sum (£193 million: see below) to Numology Limited under the Research Agreement for research and development of successful vaccines. There were originally four such patents and inventions, but two further patents, relating to hepatitis B and rotovirus A, were subsequently added: see below. Numology Limited, in turn, paid PepTcell Limited £14 million under the Research Sub-Contract for the relevant research and development. Under the Licence Agreement, Numology Limited had to pay the guaranteed licence fees to the Partnership (which obligation Numology Limited retained, while also assigning the benefit and burden of the Licence Agreement to PepTcell Limited). Under the Licence Agreement, once assigned by Numology Limited to PepTcell Limited, PepTcell Limited was obliged to pay to the Partnership 10% royalties in respect of the proceeds of any successful exploitation of a developed vaccine, which sum, the parties agree, might be very large.

15. The FTT referred to an explanatory Memorandum entitled, "Vaccine Research Limited Partnership" ("the Memorandum") (FTT, paragraphs [6]-[15]), which analysed the effects of an investment of £1 million by a hypothetical limited partner into the Partnership. The FTT and concluded:

> "The picture that emerges for the £1 million investor is as follows. He or she takes out an £800K loan and contributes a further £270K on joining The Partnership in 2006-07. He or she has the assurance that a guaranteed minimum licence fee will meet the costs of repaying the loan of £800K and interest in full. So - although the debt was in the form of a full recourse loan - the borrower would be entitled to assume that in reality he or she would have no further concerns about meeting the liability once the initial paperwork was completed. As to the additional £270K he or she must find, that would be met in full in due course by the £419,600 refund payable by HMRC to him

> or her in respect of sideways loss relief after 5 April 2007 [that being the effect of setting about £1 million of deductible expenditure incurred by the Partnership as "qualifying expenditure", which the Memorandum assumed would be deductible in the investor's hands, against income otherwise taxable at 40% in the hands of the investor, thus reducing the investor's income tax charge by £419,600] ... Within one year, according to the plan, the investor would have received a net benefit in the form of a tax refund (so not further taxable) which would be worth 1.6 times his or her original risk capital of £270,000." (FTT, paragraph [15]).

In other words, the FTT found, at FTT, paragraph [15], that the tax refund constituted a return to the investors quite apart from any royalties payable in respect of a successfully developed vaccine.

16. The FTT further found as a fact (FTT, paragraph [62]) that "[t]he commerciality of the investment to an investor [in the Partnership] ... did not depend in practical terms to any extent on the possible returns from ... royalties [payable in respect of a successfully developed vaccine]. If the Scheme worked as planned, there would be a clear return on the investment [in the form of a tax repayment] within a much shorter period...".

17. Turning to the specific cash flows involved in these appeals, the FTT found these to be as follows (FTT, paragraph [45]):

    (1) the underlying total sum that the Partnership and Mr Vaughan state was invested in the Partnership was £193,102,126.20 ("the Total Sum");

    (2) the Total Sum was derived as to £107,278,959 from the capital contributions of the Class B Limited Partners and as to £85,823,167.20 from the capital contribution of the Class A Limited Partner, Numology Limited (a special

purpose vehicle with a share capital of £2, held by a charitable trust: FTT, paragraph [58]). In addition, £7,082,552 was payable in fees, this being derived from the Class B Limited Partners' contributions (there being no other source shown);

(3) of the sums contributed by the Class B Limited Partners, 80 per cent of the total, after fees were deducted, was drawn from the funds provided by BOS as part of the Scheme. Eighty per cent of the net sums contributed from the Class B Limited Partners (as stated in sub-paragraph (2) above) is £85,823,167.20. This is equal to the sum contributed by the Class A Limited Partner, Numology Limited. We observe that what the FTT found, as summarised in the previous two sub-paragraphs, is that in broad terms the Class B Limited Partners borrowed £86 million from BOS on commercial terms (this was common ground between the parties before us) and contributed £28 million from other sources which the Class B Limited Partners arranged themselves (see also FTT, paragraph [57]). Numology Limited also contributed about £86 million (at least in terms of the documentation: the FTT found that Numology Limited's contribution was properly ignored: see below);

(4) the Total Sum of about £193 million was paid by the Partnership to Numology Limited under the Research Agreement;

(5) against the Total Sum which it received, Numology Limited paid out its capital contribution to the Partnership; £85,936,665.89 to a deposit account with RBS together with a fee to RBS of £343,766.48; £14,000,000 to PepTcell Limited under the Research Sub-Contract; and £6,399,091.34 to MSF as a fee

("the Matrix fee", which is the subject of the fee deductibility issue. Other fees paid by the Partnership totalled £599,435.29;

(6) these sums were all transferred on 16 and 17 August 2006.

(7) the sums paid to RBS were the sums required as deposit and fee for the letter of credit behind the guaranteed licence fees;

(8) there were some smaller sums involved both as disbursements and receipts (including interest), but the total of the main payments made by Numology Limited to third parties other than the Partnership (that is: the RBS deposit and fee, the PepTcell Limited payment and the Matrix fee) came to £107,362,984.38.

18. The price of about £193 million paid by the Partnership to Numology Limited under the Research Agreement was a non-refundable fee (Clause 4.2 of the Research Agreement) in consideration of "Services [being research and development of specified vaccines] to be performed by Numology Limited". The Research Agreement provided that the Services were to be performed by Numology Limited or an "Appointed Sub-Contractor" (which was to be PepTcell Limited: See Clauses 1.1 and Clause 3.1 of the Research Agreement), "in accordance with the Schedule [to the Research Agreement]" (Clause 3.1). The Schedule costed various "steps" to be taken in providing these research and development Services, which totalled approximately £193 million. These costs, which were reflected in the consideration price payable by the Partnership to Numology Limited under the Research Agreement (FTT, Annex B, paragraph [37]), were based on the deemed cost of what the parties termed a

"methodical approach" (or traditional approach) to vaccine development, consisting of "trial and error - the systematic creation as a vaccine of each protein comprised within the conserved elements of a virus" and then the progressive testing of each such vaccine to see if it was efficacious and safe (FTT, Annex B, paragraph [12]).

19. However, the development work which it was contemplated would in fact be carried out by PepTcell Limited would not be in the form of the methodical approach, but rather would take the form of a new, much cheaper approach to research, involving computer modelling. The price paid by Numology Limited to PepTcell Limited under the Research Sub-Contract, under which PepTcell Limited was to provide "Services" identical to those specified in the Research Agreement (see Clause 3.1 and the Schedule to the Research Sub-Contract), was only £14 million (Clause 4.1 of the Research Sub-Contract).

20. PepTcell Limited considered that it had discovered an evaluation mechanism predictive process which did not involve full methodical testing and thus provided a short cut to the identification of effective vaccines for multiple diseases (FTT, Annex B, paragraphs [14]-[15]). This evaluation process was termed the "Algorithm." PepTcell Limited considered that the Algorithm significantly reduced the actual research needed to identify proteins to be used as bases for vaccines (FTT, Annex B, paragraph [17]). PepTcell Limited was sensitive to the commercial value of the Algorithm and made an effort to keep the Algorithm's content and nature confidential (FTT, Annex B, paragraph [16]).

21. However, the FTT found "that in reality no one expected the research to be conducted in a full methodical way and that PepTcell Limited was not funded to do that." (FTT,

Annex B, paragraph [34]). It concluded that "PepTcell Ltd had no expectation, plan or capacity to undertake the research project otherwise than by the use of the Algorithm...and that Numology Ltd had no expectation that it would do so" (FTT, Annex B, paragraph [35]); and accordingly the FTT did "not find that the costs calculation for a methodical approach to the research to be the agreed way forward for the research or the way that the documents show that research was going forward ... [and to that extent the FTT did] not accept ... [that] the contract showed that the research would be conducted by the methodical method without any use of the Algorithm ... it was a possibility but no more than that" (FTT, Annex B, paragraph [37]). The FTT also found that "... evidence about the desire of the investors to have a share in a very large profit suggests that [Mr Stoloff, the managing director of PepTcell Limited] knew that at least some of those involved in the Partnership knew this as well" (FTT, Annex B, paragraph [35]).

22. Thus the FTT found that the Research Agreement set out both a price (£193 million) and a basis for the relevant research (as specified in Clause 3.2 of the Research Agreement) which reflected the "methodical approach", which Numology Limited and PepTcell Limited never intended to be used, and that PepTcell Limited, through its managing director, knew that at least some of those involved in the Partnership knew this to be the case. On the other hand, the Research Sub-Contract, under which PepTcell Limited was to undertake research and development, was concluded on the basis, so the FTT found, that PepTcell Limited would use the Algorithm, which explained the lower price of £14 million, since the cost of the actual research which would be done would be reduced. PepTcell Limited's work under the Research Sub-Contract would, of course, also be work done as an "Appointed Sub-Contractor"

under the Research Agreement, which permitted Numology Limited to complete its obligations to the Partnership under the Research Agreement.

23. The FTT identified what sums came into the Scheme and where those sums went, as follows. The key cash flows took place on 16 and 17 August 2006. The FTT found (FTT, paragraphs [57] and [61]) that the reality of what happened during that period was that the Class B Limited Partners contributed £114 million of capital to the Partnership; this was funded as to £86 million by the agreed loans arranged with BOS, and as to the balance of £28 million by other sources arranged by the individual Class B Limited Partners; the £86 million of loans arranged between the Class B Limited Partners and BOS represented 80 per cent of the available capital of the Partnership after the agreed fees of £7 million had been deducted. More specifically, the FTT found (FTT, paragraph [61]) that the final total of sums raised from the Class B Limited Partners was £114,361,511.

24. The FTT summarised its findings on the various cash flows as follows: "In round terms the £114 million from the Class B Limited Partners was paid as to £85.9 million on the RBS deposit against the letter of credit, as to £14 million to PepTcell Limited, as to £0.9 million in fees to RBS and others and as to £13.4 million in fees to [MFS]." (FTT, paragraph [65]).

25. The FTT made important further findings of fact, as follows. First, the FTT accepted, and found as a fact, that the £14 million paid to PepTcell Limited under the Research Sub-Contract was paid under a genuine commercial agreement and was paid expressly for pharmaceutical research and development within the meaning of section

437 of the CAA 2001. The FTT also made findings as to how it was spent over the next few years (FTT, paragraphs [46], [63], [70] and , [71]).

26. Second, the FTT observed that PepTcell Limited was "genuinely engaged in attempting to secure a successful outcome to its activities" (FTT, paragraph [82]) and that "in this area of commercial activity there can be significant delays between initial investment and eventual reward" (ibid.). The FTT also accepted that "... agreements were in place under which the [Class B] Limited Partners would receive a share of any successful development of vaccines ..." (ibid.). HMRC also accepted this (FTT, paragraphs [17] and [29]; Annex B, paragraph [29]). The FTT found that two elements of the research and development undertaking (the research and development relating to hepatitis B and rotavirus A) were "additions based on pragmatic expediency rather than either clear science or clear market due diligence" (FTT, Annex B, paragraphs [22]-[23] and [31]), but this finding did not, anywhere in the FTT's decision, qualify the FTT's finding that the activities of PepTcell Limited were genuine and relevant research and development.

27. Third, however, the FTT found (FTT, paragraph [62]), relying on the Memorandum, that so far as the Class B Limited Partners were concerned, they would receive, if "all went according to plan", substantial tax refunds (by way of "sideways loss relief") which would exceed the amounts contributed to the Partnership from their own resources while at the same time the amounts borrowed from BOS would have been paid off, with interest, by the guaranteed licence fees (FTT, paragraph [62]). The FTT further found that there was no evidence of any prospect of the Class B Limited Partners receiving the 10% royalties (payable by PepTcell Limited) from any successful development of vaccines at the date of the hearing or in the near future, so

that "the commerciality of the investment [i.e. of making contributions to the Partnership] to an investor [the Class B Limited Partners] ... did not depend in practical terms to any extent on the possible returns from those royalties [since] [i]f the Scheme had worked as planned, there would be a clear return on the investment [sc. from the reduction of the Class B Limited Partners' income tax liability due to "sideways loss relief"] on a much shorter period than that inevitable in pharmaceutical research and...a term with none of the usual risks of an investment in pharmaceutical research" (FTT, paragraph [62]).

28. Fourth, the FTT found that "Evidence was put before us that enquiries were made by Class B Limited Partners and by agents employed by the Partnership to monitor the activities of PepTcell Ltd [but that] evidence itself is not entirely persuasive ... we find, on balance, that in so far as the funding [of £14 million] went through [from the Partnership] to PepTcell Ltd, and arrangements were in place to monitor the activities of PepTcell Ltd, to that extent the Class B Limited Partners were engaged in trading activities" (FTT, paragraph [76]). We shall re-visit this finding when we consider the trade issue.

29. Fifth, the FTT found (FTT, paragraph [82]) that "[keeping] the same focus in mind as [was taken] when examining whether the activities [of the Partnership] were trading activities (namely with regard to the £14 million [paid to PepTcell Limited]), we are also prepared to find on balance that the activities linked to the sums paid to PepTcell Ltd were incurred on a commercial basis in such a way that profits could be expected to arise within a reasonable time" (FTT, paragraph [82]: we revisit this finding when we consider the commercial basis issue).

30. Sixth, the sum stated to have been contributed by Numology Limited in its capacity as a partner of the Partnership (£85,823,167) was, as the FTT found, not available to the Partnership for expenditure "on" research and development, since Numology Limited's contribution was not, in reality, new money (FTT, paragraph [58]) or separate funding (FTT, paragraph [61]). The FTT found that "the only significant source of funds available to Numology Ltd...was from the funds paid across...to Numology Ltd from the contributions by the Class B Limited Partners" (FTT, paragraph [59]), so that "the element of funds said to be contributed by Numology Ltd to the Partnership was funded entirely from the contributions of the Class B Limited Partners" (FTT, paragraph [60]). The FTT therefore considered Numology Limited's contribution of £85,823,167 as irrelevant to the claim made, both as a matter of law and as a matter of fact (FTT, paragraph [61]). The FTT also observed that "This [conclusion] corresponds to the view formed as a matter of law by the Tribunal...that the Partnership has no separate existence in law from the individual partners for the purposes of income tax" (FTT, paragraph [60]).

31. Seventh, the FTT found (FTT, paragraph [61]) that the maximum sum that, on any analysis, could be regarded as available for expenditure by the Partnership on research and development was the sum raised from the contributions from the Class B Limited Partners (i.e. £114, 361,511). The FTT described this amount as the total of the funding introduced from outside the Scheme to the Partnership (FTT, paragraph [61]).

32. Eighth, the FTT found that the amount expended by the Partnership on research and development was limited to the £14 million paid to PepTcell Limited under the Research Sub-Contract (FTT, paragraphs [64]-[68]).

33. Ninth, importantly, the FTT found as a fact (FTT, paragraph [67]) that the sums the FTT considered to have been paid from the Class B Limited Partners' contributions which related to the guaranteed licence fees (which served to repay the loans taken from BOS) constituted a "self-contained financing arrangement" (FTT, paragraph [66]) which were "part of the Scheme but separate from payment of £14 million made to PepTcell Ltd by Numology Ltd to secure research and development of the intended kind" (FTT, paragraph [67]). In making this finding, the FTT observed that "[t]he sums paid for the guaranteed licence fees are clearly identified in the accounts and agreements identified above [i.e. in the documents which implemented the Scheme] ... [and that] the only source of funds for the payment deposited with RBS to obtain the letter of credit to guarantee the licence fees on the evidence before us was the flow of funds from the capital contributions of the Class B Limited Partners" (FTT, paragraph [67]). The FTT relied on its summary of the relevant cash flows to conclude that "... a fundamental part of the Scheme was the arrangement with BOS and RBS for the provision of loans representing around 80% of the total investment by each Class B Limited partner...whereby the capital paid over by the Partnership was used to pay for the guaranteed licence fee which itself was used to pay the full capital and interest payments incurred by each partner in taking out those loans" (FTT, paragraph [66]). The FTT did not accept that this financing arrangement was a trading activity (FTT, paragraphs [76] and [83]).

34. To summarise, the FTT made the following findings of fact:

(1) the Memorandum makes it clear that investors who invest in the Partnership expect to receive a return based on tax relief ("sideways loss relief") on a

proportion of the total sum described as paid by the Partnership to Numology, namely £193 million (FTT, paragraphs [15] and [62]);

(2) of the payment of £193 million by the Partnership to Numology Limited under the Research Agreement, on any view only £114 million was available for expenditure on research and development. This £114 million was the Class B Limited Partners' contributions, which comprised £86 million borrowed from BOS and £28 million from other sources arranged by the Class B Limited Partners (FTT, paragraph [57]);

(3) in particular, the contribution of Numology Limited to the Partnership was not available for expenditure by the Partnership on research and development of vaccines. This was not a payment from "outside the Scheme". It was not "new funding." Accordingly, it fell to be ignored in assessing the amount of funds available for expenditure "on" research and development (FTT, paragraphs [58]-[60]);

(4) the payment of £14 million by the Partnership to Numology Limited under the Research Agreement was payment for genuine research services (when considered in conjunction with Numology Limited's payment of £14 million to PepTcell Limited under the Research Sub-Contract), given that PepTcell Limited was by payment of this amount trying to secure success in developing vaccines (FTT, paragraphs [70]-[71]);

(5) the Partnership's funding of PepTcell Limited (under the Research Agreement, via payment under the Research Sub-Contract) and the Partnership's

monitoring of PepTcell Limited's activities amounted to a trade for income tax purposes; and it also qualified as a trade conducted on a "commercial basis" (FTT, paragraphs [74]-[76], see also FTT, paragraph [82], to which we refer below);

(6) but the £85.8 million, out of the £114 million invested by the Class B Limited Partners, which funded the RBS deposit which in turn funded the "guaranteed licence fee", was a self-contained financing arrangement separate from the genuine trading activity which required the funding of PepTcell Limited; this separate financing arrangement was not part of a trading activity (FTT, paragraphs [66]-[67]).

The Law

35. In relation to the Partnership's appeal, the relevant provisions dealing with "qualifying expenditure" were, at the material times, contained in section 437 to 451 CAA 2001. At the material times, these provided in relevant part as follows:

> "437 **Research and development allowances**
>
> (1) Allowances are available under this Part if a person incurs qualifying expenditure on research and development.
>
> (2) In this Part "research and development" –
>
> (a) has the meaning given by section 837A of ICTA (activities falling to be treated as research and development under generally accepted accounting practice, subject to regulations ...
>
> (3) But –

(a) activities that, as a result of regulations made under section 1006 of ITA 2007, are "research and development" for the purposes of that section are also "research and development" for the purposes of this Part, and

(b) activities that, as a result of any such regulations, are not "research and development" for the purposes of that section are also not "research and development" for the purposes of this Part.

438 **Expenditure on research and development**

(1) Expenditure on research and development includes all expenditure incurred for –

(a) carrying out research and development, or

(b) providing facilities for carrying out research and development.

(2) But it does not include expenditure incurred in the acquisition of –

(a) rights in research and development, or
(b) rights arising out of research and development.

...

439 **Qualifying expenditure**

(1) In this Part "qualifying expenditure" means capital expenditure incurred by a person on research and development directly undertaken by him or on his behalf if –

(a) he is carrying on a trade when that expenditure is incurred and the research and development relates to that trade, or

(b) after incurring the expenditure he sets up and commences a trade connected to the research and development.

...

(3) The trade by reference to which expenditure is qualifying expenditure is referred to in this Part as "the relevant trade" in relation to that expenditure.

(4) If capital expenditure is partly within subsection (1) and partly not, the expenditure is to be apportioned in a just and reasonable manner.

441 **Allowances**

(1) A person who incurs qualifying expenditure is entitled to an allowance in respect of that expenditure for the relevant chargeable period equal to –

(a) the amount of the qualifying expenditure ...

(2) The relevant chargeable period is –

(a) the chargeable period in which the expenditure is incurred ...

450 **Giving effect to allowances and charges**

An allowance ... to which the person is entitled ... under this Part for a chargeable period is to be given effect in calculating the profits of the relevant trade, by treating –

(a) The allowance as an expense of the trade ..."

36. Thus, so far as is material on this appeal, in order to have incurred "qualifying expenditure" within the scope of section 437 CAA 2001:

(a) the Partnership must have been undertaking a trade in the relevant period (section 439(1)(a), which gives rise to the trade issue);

(b) the expenditure must have been expenditure "on" research and development (section 439(1), which gives rise to the quantum issue); and

(c) the expenditure must have "relate[d]" to that trade (section 439(1)(a)).

If these conditions are met, the "qualifying expenditure" is to be treated as a trading loss, i.e. as a trading loss of the Partnership.

37. It is convenient to note at this point that Mr Prosser asked for permission to raise a point which was not argued before the FTT. This new point was to the effect that, even if the Partnership did undertake a trade and incurred expenditure "on" research and development, such expenditure did not "relate" to the Partnership's trade, for the purposes of section 439(1)(a) (it was common ground that section 439(1)(b) was not relevant to this appeal). We did not give permission for this point to be argued. To the extent that the argument overlaps with the quantum issue (the extent to which the Partnership expended monies "on" research and development), it is otiose. And to the extent that this new point raises issues which are distinct from the quantum issue, it inevitably raises questions of fact, namely as to the relationship of any expenditure to the Partnership's trade, as properly identified. If permission were given for HMRC to raise this new point on the appeal, the Partnership and Mr Vaughan would have been unfairly prejudiced by being deprived of the opportunity to deal with it by calling full evidence relevant to the point at the appropriate time, at the hearing before the FTT. In our judgment, therefore, it would have been unjust to the Partnership and Mr Vaughan to grant permission to HMRC to take this new point on appeal.

38. Turning to Mr Vaughan's appeal, the provisions concerning so-called "sideways loss relief" were, at the material times, contained in the Income and Corporation Taxes Act 1988 ("ICTA 1988").

39. At the material time, section 381 of ICTA 1988 provided in relevant part as follows:

> "(1) Where an individual carrying on a trade sustains a loss in the trade in –
>
> (a) the year of assessment in which it is first carried on by him ... he may ... make a claim for relief under this section.

...

> (4) Relief shall not be given under subsection (1) in respect of a loss sustained in any period unless ... the trade was carried on throughout that period on a commercial basis and in such a way that profits of the trade ... could reasonably be expected to be realised in that period or within a reasonable time thereafter."

40. Partners are treated as carrying on the trade of the partnership of which they are members: section 848 of the Income Tax (Trading and Other Income) Act 2005 ("ITTOIA 2005"). Thus trading losses of the Partnership are treated as trading losses of the partners, including Mr Vaughan, in proportion to their interests in the Partnership.

41. Section 381 of ICTA 1988 gives further relief, by permitting "sideways loss relief", that is to say, by permitting trading losses of the Partnership attributable to individual partners to be set off as losses against other income which is otherwise taxable to income tax in the hands of those partners. However, by virtue of section 381(4), this valuable benefit of "sideways loss relief" is dependent, inter alia, on a trade being carried on on a commercial basis. This gives rise to the commercial basis issue.

42. At the material time, section 391 of ICTA 1988 further provided in relevant part as follows:

> "In the case of a loss sustained in a trade, profession or vocation carried on wholly outside the United Kingdom, relief under ... sections 380 to 386 ... is given only on –
>
> *(a)* the profits of a trade, profession or vocation carried on wholly outside the United Kingdom .,."

43. This provision gives rise to the trade location issue. If the Partnership sustained relevant losses in a trade carried on wholly outside the United Kingdom, section 391 becomes relevant, in that it restricts sideways loss relief in such a case to profits of a trade, profession or vocation conducted wholly outside the United Kingdom.

The Issues raised in this Appeal

44. We first address the issues raised in respect of the Partnership and whether the Partnership has incurred "qualifying expenditure" (the trade issue and the quantum issue). We then turn to the issues in respect of Mr Vaughan and his claim for sideways loss relief (the commercial basis issue and the trade location issue). We then deal separately with the interest relief issue and the fee deductibility issue.

The Trade Issue

45. The main part of the FTT's reasoning on this issue is at FTT, paragraphs [72]-[76].

46. Section 439 of CAA 2001 (in defining "qualifying expenditure" for the purposes of section 437(1) of CAA 2001) requires that the person who has incurred the expenditure has been "carrying on a trade when that expenditure is incurred". This gives rise to the trade issue. The FTT found that the Partnership did carry on a trade at the relevant time. On appeal, HMRC challenge this finding.

47. Although the FTT does not expressly refer to its findings on the Research Agreement and the Research Sub-Contract in reaching its conclusions on the trade issue, the FTT obviously had well in mind its findings about the operation of the Scheme. In particular, on the trade issue, it is important to recall that the FTT found that:

(1) the Partnership activity comprised making and executing the Research Agreement, whereby the Partnership paid £193 million to Numology Limited in contemplation of the Research Sub-Contract, whereby Numology Limited paid £14 million to PepTcell Limited to be the "Appointed Sub-Contractor" under the Research Agreement and the counter-party to Numology Limited under the Research Sub-Contract (FTT, paragraph [20] and Clauses 1.1 and Clause 3.1 of the Research Agreement); and

(2) PepTcell Limited's research activities were genuine (FTT, paragraphs [46], [63] and [82]).

48. It is in the light of that background that we must scrutinise the FTT's decision on the trade issue.

49. The essence of the FTT's decision is found at paragraphs [74] to [76] of its decision, including the following:

> "74 We were taken to a number of authorities on the meaning of "trade" by both parties, including leading authorities and similar fact analogies. We do not consider that it is necessary to explore either group of those authorities here. "Trade" is another word that on the highest authority is to be given its ordinary meaning in the light of the facts of a particular case. In this case, we have already established that the total sums said to have been spent on setting up the Scheme do not qualify as research and development expenditure save to the extent of the £14 million paid to PepTcell Limited and any linked expenses. This does not include either the sums said to have been invested by Numology Limited in the Partnership or the sums deposited with RBS so that RBS would guarantee the licence payments [Earlier in the decision, the FTT had found that the payments attributable to the deposit which secured the guaranteed licence fees were separate from any trading activities of

> the Partnership and were not trading arrangements: see FTT, paragraphs [66]-[67]]...
>
> 76 If we focus on the £14 million paid through Numology Limited to PepTcell Limited, we see a stronger argument that there were trading activities. Evidence was put before us that enquiries were made by Class B Limited Partners and by agents employed by the Partnership to monitor the activities of PepTcell Limited. That evidence itself is not entirely persuasive. We comment in our findings on the scientific evidence, for example on the disparity between the evidence about the need to move fast in the research programme to stay ahead of possible competition and the actual speed at which PepTcell Limited undertook some of the research. But we find, on balance, that in so far as the funding went through to PepTcell Limited, and arrangements were in place to monitor the activities of PepTcell Limited, to that extent the Class B Limited Partners were engaged in trading activities. We do not accept that the arrangement of the guaranteed licence fee was a trading activity."

50. The FTT's conclusion that the Partnership was carrying on a trade, to the extent of the funding and monitoring of PepTcell Limited, may be summarised as follows:

(a) "Trade", for income tax purposes, takes its "ordinary" meaning (FTT, paragraph [74]);

(b) PepTcell Limited was the "Appointed Sub-Contractor" under the Research Agreement and undertook obligations under the Research Sub-Contract to enable Numology Limited to meet its obligations under the Research Agreement (Clauses 1.1 and Clause 3.1 of the Research Agreement);

(c) PepTcell Limited's activities were genuine and within the scope of section 437(1) of CAA 2001 (FTT, paragraphs [46], [63], [70] and [71]);

(d) PepTcell Limited was funded by the Partnership to the extent of £14 million (ibid.);

(e) the payments attributable to the "self contained financing arrangement" concerning the guaranteed licence fees were separate from the Partnership's trading activity in relation to PepTcell Limited; this financing arrangement was not itself a trading activity (FTT, paragraphs [66]-[67]);

(f) although not conclusive ("not entirely persuasive"), the FTT nonetheless felt able to find that the funding and monitoring of PepTcell Limited amounted to the carrying on of a trade (FTT, paragraph [76]).

51. Mr Peacock defended the FTT's reasoning that the Partnership was trading, albeit he also contended that it should have gone further in its findings regarding the extent of that trading (see the discussion of the quantum issue, below).

52. Mr Prosser submitted that the FTT's reasoning was inherently contradictory, in that having found the evidence to be "not entirely persuasive", the FTT nonetheless concluded the Partnership was trading. Further, Mr Prosser submitted that the two factors on which the FTT relied, being the funding of PepTcell Limited and the monitoring of PepTcell Limited's research activities, were just as apt to describe investment activities and were, accordingly, an inadequate basis on which to conclude that the Partnership was trading. Mr Prosser also said that the FTT had failed to identify who the "customers" of the Partnership were, which constituted a further flaw in its reasoning, since the presence of "customers" is a necessary component of any trading activity.

Discussion

53. "Trade" is defined in section 832 of ICTA 1988 as "including every trade, manufacture, adventure or concern in the nature of trade". It may be unhelpful to apply a test of "trade" based simply on a Tribunal's impression regarding its "ordinary" meaning, given that there is substantial authority which exists on the meaning of the term, as was cited to the FTT (see FTT, paragraph [74]). "Investment" and the phrase "non-business activity" also have ordinary meanings. In distinguishing one from another for the purposes of the operation of the tax code, a fact-finding tribunal should make it clear what are the distinguishing features of each type of activity when explaining which categorisation is treated as appropriate in a particular factual context. In this case, HMRC accept that the Partnership undertook a "business" at the material times: see FTT, paragraph [46]. The FTT needed to set out a proper basis for finding whether or not the Partnership's business qualified as the carrying on of a trade.

54. "Trade" has been defined on high authority as "operations of a commercial character by which the trader provides to customers for reward some kind of goods or services": *Ransom v Higgs* [1974] 3 All ER 949, HL, at 955, per Lord Reid; see also Lord Wilberforce at 964. Thus a "trader" requires a commercial element to his activities, identifiable goods or services, customers and a putative reward. It is well established that the question of whether or not there is a trade is one of fact: see *Edwards v Bairstow.*

55. So far as the FTT's treatment of the evidence goes, we think that, on a fair reading of the decision, the FTT in saying that the "evidence before [the FTT]...[was] not

entirely persuasive" (FTT, paragraph [76]) was merely saying that such evidence (being the documentary evidence considered by the FTT and oral evidence, including expert evidence, which it heard) was not of itself conclusive beyond all doubt, but nevertheless allowed the FTT to conclude that "on balance the Class B Limited Partners were engaged in trading activities [by reference to the funding of PepTcell Limited and the monitoring of PepTcell Limited's activities]." In our judgment, this is a perfectly sustainable and lawful conclusion of fact on the balance of probabilities, rationally based on adequate supporting evidence.

56. It is true that the FTT should, strictly speaking, at this point in its decision have referred to the "Partnership" rather than to the "Class B Limited Partners". It was the activity of the Partnership which was in question in relation to the trade issue. The absence of any "veil" of incorporation between a partnership as an entity and the members of that partnership as a matter of English private law and the requirement to look through a partnership's affairs to the partners in it for the purposes of certain parts of the tax code (see section 848 of ITTOIA 2005: partnership not to be treated as an entity distinct from the partners) does not mean that the existence of a partnership is always to be ignored altogether for income tax purposes. But this slip in the language used by the FTT is immaterial. It is clear that the substance of the FTT's analysis is properly directed to the engagement of the Partnership itself in activities which could properly be identified as the carrying on of a trade. This slip does not affect the force of the FTTs' conclusions on the evidence before it on the trade issue, as an issue in respect of the activity of the Partnership.

57. The Research Agreement, the Sub-Research Contract (and the other documentation which implemented the "Scheme") were all "commercial" in the sense that they had

as part of their objective research and development of a vaccine or vaccines which it was hoped would yield royalties and the royalties which might become due under the Research Sub-Contract were clearly a "reward" from PepTcell Limited (which was, at the same time, the "Appointed Sub-Contractor" under the Research Agreement, subject to an obligation to develop successful vaccines, and the Partnership's "customer" under that Agreement, who paid for the right to exploit the patents and inventions held by the Partnership by agreeing to pay the royalties). The royalties were not income simply to be enjoyed by the Partnership qua owner of an income producing asset. The Partnership had to fund the activities of PepTcell Limited, via its arrangements to fund Numology Limited, to carry out research and develop the vaccines into something which might ultimately prove to be marketable so as to generate an income. Nor did the royalties represent simply a form of capital appreciation, for the same reasons. The Partnership had to arrange for research and development activities to be funded and carried out in order to have any hope of a return on its assets. Accordingly, in the circumstances of this case, the Partnership's activity could not be regarded as merely making an investment in an income producing or capital appreciating assets. The FTT was plainly entitled to consider the Partnership's activity to be business or commercial activity, which did not have the character of investment activity; similarly, the FTT was plainly entitled to consider that the Partnership's activity was trading activity.

58. In our judgment, there are no good grounds for interfering with the FTT's conclusion in this regard. Therefore, HMRCs' appeal on the trade issue is dismissed.

The Quantum Issue

59. The main part of the FTT's analysis on this issue is at FTT, paragraphs [54]-[71].

60. Sections 437(1) and 439(1) of CAA 2001 have the effect of restricting "qualifying expenditure" to expenditure incurred "on" research and development. This gives rise to the quantum issue.

61. The FTT articulated the quantum issue as one of fact (citing *Tower MCashback LLP v HMRC* [2011] UKSC 19 - "*Tower MCashback*"), which was to be tested as a matter of practical commercial common sense, based on a realistic appraisal of the facts (citing *Barclays Mercantile Finance Limited v Mawson* [2005] 1 AC 684 - *"BMBF"*) (FTT, paragraphs [56]-[57]).

62. The FTT scrutinised the quantum of funding available to the Partnership and sought to identify exactly on what that funding was spent ("What came in and where did it go?"). The main part of the FTT's reasoning relevant to this issue is found at FTT, paragraphs [57] to [59]:

> "57 In our view, the first essential issue is to identify what sums came into the Scheme. Then we must identify where those sums went. The key cash flows took place on 16 and 17 August 2006. We find that the reality of what happened during that period was that the Class B Limited Partners contributed £114 million of capital to the Partnership. This was funded as to £86 million by the agreed loans arranged with BOS, and as to the balance of £28 million by other sources arranged by the individual Class B Limited Partners....
>
> 58 The Scheme as presented to us showed that at the same time Numology Limited contributed an amount equal to the total sums raised by the Class B Limited Partners through the BOS loans (£86 million) as its share of the

Partnership's capital as the Class A Limited Partner. We agree with Mr Prosser that this was not new money, whether or not it can be described as circulating capital or a set off... Numology Limited... was a special purpose vehicle with a share capital of £2, both shares being owned by trustees for a charitable trust. We were offered no evidence that it raised any further capital at any relevant period either by raising equity or by any formal bond, or similar arrangement.

59 The only significant source of funds available to Numology Limited on the evidence before us was from the funds paid across at that time to Numology Limited from the contributions by the Class B Limited Partners. This is supported by a letter sent to the Partnership by BOS setting out transactions for the period to 5 April 2007. This commented that some of the sums involved had been set off against each other or settled net as allowed in various agreements."

63. The FTT therefore made the following findings at FTT, paragraphs [61]-[68] and [82], as follows:

"61 We are told, and accept, that the final total of sums raised from the Class B Limited Partners was £114,361,511. (This was comprised of the £107 million capital contributions and the £7 million in fees to Matrix). We take the view that that is the maximum sum that, on any analysis, can be regarded as available for research and analysis, can be regarded as available for research and development. That is the total of the funding introduced from outside the Scheme to the Partnership. The sum stated to have been contributed by Numology Limited in its capacity as a partner of the Partnership, a sum amounting to £85,823,167, is not in reality separate funding. It is not therefore relevant to the claim made both as a matter of law and as a matter of fact.

62 We therefore focus on the sums paid in by the Class B Limited Partners. What, adopting a practical commercial approach, did the Class B Limited Partners receive for their investment? The analysis in the example taken from the Memorandum shows that the practical commercial outcome, if all went according to plan, was that they would receive as tax refunds substantial sums to be set off against other taxable liabilities. Those sums would exceed the amounts they invested in the Scheme from their own resources. They would also receive

guaranteed licence fees that completely met the £123.77 million obligations they had incurred in the loans from BOS which they had invested in the Scheme. In addition they would be entitled, in due course, to a share in any royalty income that might result from the research and development being undertaken on their behalf. But we were offered no evidence that such sums were being received at the date of hearing or were in prospect at that date or that there was any strong evidence of them being received in the near future. The commerciality of the investment to an investor, we find as fact, did not depend in practical terms to any extent on the possible returns from those royalties. If the Scheme worked as planned, there would be a clear return on the investment within a much shorter period than that inevitable in pharmaceutical research and, as the Scheme itself used as a selling point, a term with none of the usual risks of an investment in pharmaceutical research.

63 ... We accept... and find as fact, that the £14 million paid to PepTcell Limited was paid under a genuine commercial agreement and was paid expressly for pharmaceutical research and development. And that, over the next few years, was the way it was spent.

64 Was any other aspect of the monies raised spent **on** research and development? The total available was the £114 million raised from Class B Limited Partners. Of that, £14 million was paid to PepTcell Limited. Evidence before us showed that £85,936,665.89 was paid by Numology Limited to RBS for the required deposit for the letter of credit and together with fees the payment totalled £86.9 million. This was funded from the sums paid to Numology Limited from the contributions of the Class B Limited Partners. We find this because again we were given no evidence of any other source of funds available to Numology Limited at the time.......

65 In addition, Numology Limited paid fees to Matrix of £6.33 million on completion of the Scheme. There were other small sums received by The Partnership, for example as interest, and other sums paid out during the accounting period to 5 April 2007, but no other sums of major significance. In round terms the £114 million from the Class B Limited Partners was paid as to £85.9 on the RBS deposit against the letter of credit, as to £14 million to PepTcell Limited, as to £0.9 million in fees to RBS and others and as to £13.4 million in fees to Matrix.

66 These figures show clearly that a fundamental part of the Scheme was the arrangement with BOS and RBS for the provision of loans representing around 80 per cent of the total investment by each Class B Limited Partner in a self-contained financing arrangement whereby the capital paid over from the Partnership was used to pay for the guaranteed licence fee which itself was used to pay the full capital and interest payments incurred by each partner in taking out those loans.

67 Mr Peacock resisted this argument by reference in part to the terms of the agreement between Numology Limited and PepTcell Limited under which PepTcell Limited agreed to give a share of future royalties to Numology Limited. This came about through the chain of agreements and licences under which the Partnership was entitled to any intellectual property (termed "product technology" in the agreements) that resulted from the agreement with Numology Limited. This was then licensed back, according to the documentation, in exchange for the guaranteed licence fees and a share of any future royalties or similar payments. We do not accept that analysis as establishing that the whole of the sums raised, including the sums said to be raised from Numology Limited, were indivisible. The sums paid for the guaranteed licence fees are clearly identified in the accounts and agreements identified above. They were obligations, we find on the balance of probabilities, agreed as part of the Scheme but separate from payment of £14 million made to PepTcell Limited by Numology Limited to secure research and development of the intended kind. The only source of funds for the payment deposited with RBS to obtain the letter of credit to guarantee the licence fees on the evidence before us was the flow of funds from the capital contributions of the Class B Limited Partners.

68 We conclude that the only sums that in law can be regarded as incurred **on** research and development were the £14 million paid to PepTcell Limited together with any allowable part of the fees and expenses. So the amounts open to claim by Mr Vaughan and the other Class B Limited Partners as sums spent on research and development are their proportionate shares of that sum. Subject to the question of the deductibility of any related fees or expenses, the other sums incurred by the Class B Limited Partners are not, we find, available for any claim for research and development allowances....

> 82 ...We have no reason to question that the research and development activities of PepTcell Limited were other than genuine. Accordingly, we consider it reasonable for a profit to be expected from that investment..."

64. The FTT said that it was reinforced in its conclusion as to the quantum of the funding spent on research and development by "[the FTT's] view of the matter as one of law that "the Partnership has no separate existence in law from the individual partners for the purpose of income tax" (FTT, paragraph 60).

65. The FTT's reasoning can be summarised as follows:

    (a) the consideration price payable by the Partnership to Numology Limited under the Research Agreement was £193 million, which was based on costings based on the hypothetical use of the methodical approach to develop the vaccines (FTT, Annex B, paragraph [34]);

    (b) but, in fact, no one expected the methodical approach to be used (ibid.);

    (c) the total amount potentially available to the Partnership for expenditure on research and development was about £114 million, being the external funding introduced into the Scheme by the Class B Limited Partners (FTT, paragraph [61]);

    (d) the contribution by Numology Limited (of £86 million) was, on the facts, not available for expenditure by the Partnership on research and development (FTT, paragraphs [58]-[61]);

(e) this conclusion corresponded with the FTT's view "as a matter of law" that the Partnership had no separate existence from that of the partners for income tax purposes (FTT paragraph [60]. However, the reasons given by the FTT also explained why Numology Limited's contribution was not in fact available to be spent on research and development, and the FTT's reference to the Partnership as having no separate existence in law from the individual partners for the purposes of income tax, whilst not correct for all purposes, was an immaterial slip in this context: see also para. [56] above);

(f) of the £114 million contributed by the Class B Limited Partners, £86 million was borrowed, on commercial terms, from BOS and £28 million was found elsewhere (FTT, paragraph [61]).

(g) £14 million of this £114 million was used by the Partnership to fund PepTcell Limited and the Partnership monitored PepTcell Limited's activities so funded. This funding and monitoring amounted to a trading activity (FTT, paragraphs [17], [29], [46], [63], [70], [71] and [82]; and Annex B, paragraph [29]) (and see above in relation to the trade issue);

(h) £7 million of this £114 million was paid by the Partnership in respect of the Matrix fee and certain other fees (FTT, paragraph [61]);

(i) of the £114 million contributed by the Class B Limited Partners, £86 million was attributable to the £86 million deposited by Numology Limited with RBS to fund the letter of credit which would guarantee the payment of the licence

fees by Numology Limited through to the Class B Limited Partners (FTT, paragraphs [66]-[67]);

(j) this deposit of £86 million so as to generate the guaranteed licence fees was separate from the trading arrangement whereby the Partnership funded and monitored PepTcell Limited and was not itself a trading activity (FTT, paragraph [76]);

(k) PepTcell Limited's activities were genuine and there was a reasonable prospect of obtaining royalties at some point under the Licence Agreement (FTT, paragraph [82]);

(l) but the possibility of obtaining royalties from PepTcell Limited under the Licence Agreement did not inform the investors' notion of what made the Research Agreement "commercial" (FTT, paragraph [62]);

(m) the commerciality of an investment in the Partnership to a Class B Limited Partner ultimately depended on the availability of "sideways loss relief" (FTT, paragraph [62]). The explanation of the Scheme in the Memorandum provided the FTT with a legitimate evidential foundation on which it would properly arrive at this finding of fact (reviewed at FTT, paragraphs [6]-[16]);

(n) thus only £14 million was expended by the partnership "on" research and development and hence represented "qualifying expenditure" under sections 437 and 439 of CAA 2001 (FTT, paragraphs [63]-[67]).

66. Mr Prosser defended the FTT's reasoning and conclusions on the quantum issue.

67. Mr Peacock criticised the FTT's reasoning as flawed, on the basis that the FTT confused expenditure incurred by the Partnership (which was, Mr Peacock said, the correct statutory question) with expenditure incurred by the Class B Limited Partners. Furthermore, said Mr Peacock, the FTT, by examining what monies came in to the Scheme and where the money went, confused the question of what monies the Partnership expended "on" research and development and what the recipient (Numology Limited) did with those monies. In that regard, Mr Peacock relied on *Peterson v Commissioner of Inland Revenue* [2005] UKPC 5 ("*Peterson*") for the proposition that what is expended on paying a recipient is distinct from what the recipient does with its receipts. Mr Peacock said that the FTT was wrong to ignore the contribution of £86 million from Numology Limited in ascertaining what was available to the Partnership to expend "on" research and development. Mr Peacock further submitted that the financing of the guaranteed licence fees was not "separate" from the Partnership's trading activities. He also submitted that it was contradictory of the FTT to find that there was a reasonable expectation of profits arising from the royalties under the Licence Agreement but that the commerciality of the research Agreement stemmed from the tax relief available from "sideways loss relief." All of this meant, said Mr Peacock, that the Partnership did indeed pay £193 million to Numology Limited in order to exploit the patents and inventions assigned to the Partnership, and so expended that sum on research and development. The fact that Numology Limited then spent only £14 million under the Research Sub-Contract was irrelevant to what the Partnership had expended. The FTT's contrary approach was, Mr Peacock maintained, misconceived in the light of *BMBF* and *Tower MCashback*.

Discussion

68. We agree with the FTT that the question of what, if any, monies were expended "on" research and development is a "factual enquiry" which is answered by examining "the circumstances of each case" (*Tower MCashback*, para. [88] per Lord Hope, with whom Lord Rodger, Lord Collins, Lord Kerr, Lord Clarke and Lord Dyson agreed and with whose judgement there is no discernible difference of opinion by Lord Walker, who gave the only other reasoned judgment). The "factual enquiry" must be conducted by reference to a realistic appraisal of the facts: *BMBF,* paras. [36]-[38]; *Tower MCashback*, para. [93] per Lord Hope. In *Tower MCashback*, the House of Lords addressed the proper approach to a closely similar statutory question to that which faces us (namely, what monies were expended "on" software rights, under section 45(2) of CAA 2001). It held that expenditure must be attributed to the relevant acquisition to constitute relievable expenditure, but it may not be sufficient just to look at what was paid to acquire the rights in question: expenditure resulting in "[t]he transfer of ownership (or at least of rights) indicated the reality of at least some expenditure on acquiring those rights *but was not conclusive as to the whole of that expenditure having been for that purpose*" (*Tower MCashback*, para. [76], per Lord Walker, emphasis added). Expenditure which "*produces no economic activity*", but rather which goes "*into a loop as part of a tax avoidance scheme*", is not expenditure "on" the acquisition of software rights (*Tower MCashback*, paras. [77]-[78], per Lord Walker).

69. These propositions are in no sense contrary to the observation of the Privy Council in *Petersen* that monies might be properly viewed as expended, whatever the recipient might do with those monies. But in *Petersen*, the Commissioner for the Inland

Revenue conceded that the relevant monies were expended "on" the acquisition of a film (which was the issue in that case: see para. [46]). Such a concession on the relevant issue of fact in that case completely answered the factual question of what monies were expended "on" a particular item. But in the absence of any such concession in the present case (and HMRC emphatically made no such concession), the FTT had to ascertain what monies were in fact expended by the Partnership "on" research and development: see *Tower MCashback*, para. [92], per Lord Hope, explaining precisely this proposition in the light of *Petersen*.

70. The FTT acknowledged that Numology Limited's contribution might be "described as circulating capital or a set off" (FTT, paragraph [58]), so it did not say that the contribution by Numology Limited did not occur at all. But the FTT ascertained the amount "available" to the Partnership for expenditure "on" research and development and found that this amount excluded the contribution made by Numology Limited. The FTT then made findings of fact as to what was the Partnership's expenditure attributable to various items. Having gone through that exercise, it found that the Partnership's "qualifying expenditure" was on the facts of the case limited to expenditure of £14 million actually spent "on research and development".

71. In our judgment, the FTT's approach to the quantum issue was correct in law and its conclusion on it on the facts was justified by the evidence.

72. Turning to the specific findings of the FTT, we consider first the FTT's conclusion that the amount available to the Partnership for expenditure "on" research and development excluded the contribution of Numology Limited, as it was "not new money" (FTT, paragraph [58]) and "not in reality separate funding" (FTT, paragraph

[61]), combined with the FTT's observation that "this [conclusion] corresponds to the view formed as a matter of law by the tribunal...[that] the Partnership has no separate existence in law from the individual partners for the purposes of income tax." (FTT, paragraph [60]; see also FTT, paragraph [2]).

73. The statutory question is whether the full £193 million paid under the Research Agreement to Numology Limited was expended "on" research and development, notwithstanding that Numology Limited engaged PepTcell Limited as its "Appointed Sub-Contractor" to undertake the necessary work at a cost of £14 million (by way of the Research Sub-Contract) and that substantial parts of the total sum of £193 million were used to finance other aspects of the Scheme.

74. The FTT (at FTT, paragraph [62]) focuses on the sums paid in by the Class B Limited Partners to the Partnership, in assessing what monies were available to the partnership for expenditure "on" research and development. But that is because the FTT, at FTT, paragraph [59], had made the finding that the only significant source of funds available to Numology Limited was from the contributions made by the Class B Limited Partners and, at FTT, paragraph [61], had excluded Numology Limited's contribution from the amount which was properly viewed as "available" to the Partnership for expenditure "on" research and development. Accordingly, in our view, on a fair reading of the decision, the FTT cannot be said to have confused the question of what the Partnership is properly seen to have expended "on" research and development with what amount the Class B Limited partners have so expended. The question we have to address is, in substance, whether the FTT was correct to exclude Numology Limited's contribution from the sums purportedly expended by the Partnership "on" research and development under the Research Agreement.

75. It would, of course, be an error to say that mere circularity of funding (Numology Limited's contribution of £86 million being funded out of the £193 million payable under the Research Agreement) of itself necessarily precluded a view that the Partnership had expended monies under the Research Agreement: see *Westmoreland Investments Limited v McNiven* [2001] STC 237, paras. [13]-[16], per Lord Nicholls; *BMBF*, paras. [36]-[38] and [42]; *Tower MCashback*, para. [77], per Lord Walker. But we do not consider that this is the basis of the FTT's reasoning.

76. We should say we found the FTT's implicit appeal at FTT, paragraphs [60] and [61] (and see FTT, paragraph [2]) to section 848 of ITTOIA 2005 somewhat confusing. Section 848 does not have the effect that one can ignore analysis of the activity of the Partnership itself and of the consideration paid by the Partnership for the Services supplied by one of the partners (Numology Limited). Section 848 simply operates to attribute, following English private law, the effects of the Partnership's activity (once the nature and location of that activity are identified), in terms of allocation of profits and losses, amongst the partners for income tax purposes.

77. However, the appeal to section 848 is not the critical part of the FTT's reasoning. The basis for the FTT's decision, as also referred to in FTT, paragraph [61], is its findings on the facts about what the money available to the Partnership was used for. The FTTs' reference to the absence of "new money" and there being "no separate funding [by Numology Limited]" is, in our view, properly to be read in the context of the decision as a whole as a factual conclusion that the purported contribution by Numology Limited produced no economic activity (using Lord Walker's terminology in *Tower MCashback*) and thus cannot be said to have been expended "on" research and development. On the FTT's view, on a realistic appraisal of the facts, it was not

“available” for such expenditure: FTT, paragraph [61]. In circumstances where neither Numology Limited (in its capacity as one of the partners in the Partnership, as well as a party to the Research Sub-Contract), nor PepTcell Limited, as the counter-party to the Research Sub-Contract, expected the methodical approach (on which the £193 million figure in the Research Agreement was based) would in fact be used for the research and development work which was in fact to be carried out, the FTT was fully entitled to infer that Numology Limited’s contribution represented funds put into a loop as part of a tax avoidance scheme, and not in reality spent on research and development (cf *Tower MCashback* at para. [75]). Indeed, on the FTT’s findings of fact about the sources of funding for the Partnership and how the monies available to it were spent, we find it difficult to see what other finding of fact the FTT could have made on the quantum issue in relation to the contribution to the Partnership by Numology Limited. The FTT’s reasoning to find that of the £193 million payable to Numology Limited under the Research Agreement should, after eliminating the contribution by Numology Limited of £86 million, be reduced to a maximum of about £114 million which was potentially available for research and development cannot be impugned.

78. We turn next to the FTT’s treatment of the further £86 million element of the sum of £193 million payable by the partnership under the Research Agreement which was attributed by the FTT to the “self-contained financing arrangement” to produce the guaranteed licence fees which would allow the loans taken from BOS to be repaid.

79. The FTT found that the balance of £114 million left after eliminating the sum of £86 million attributable to the contribution by Numology Limited, was not an “indivisible sum” (FTT, paragraph [67]). On the contrary, it found that within that balance of £114

million an amount of £86 million was attributable to the "self contained financing arrangement" to produce a guaranteed licence fee income stream to repay the capital and interest on the loans taken by the Class B Limited Partners from BOS (FTT, paragraph [66]). As part of the Scheme, this amount was placed on deposit by Numology Limited with RBS, so as to generate the guaranteed licence fees which allowed those partners to repay their loans from BOS. The FTT found that this amount was separately accounted for within the Scheme and that it was agreed to be an element within the Scheme "separate from payment of [the] £14 million made to PepTcell Ltd by Numology Ltd to secure research and development of the intended kind" (FTT, paragraph [67]). The FTT's finding in this regard was underlined by its further finding that the expenditure of £14 million on research and development was part of trading activity, whereas "the arrangement of the guaranteed licence fee" was not (FTT, paragraph [76]).

80. In our judgment, the FTT was fully entitled to characterise the use of the £86 million to fund the guaranteed licence fee as an element of the Scheme which was, as a matter of practical commercial reality, separate from the trading arrangements with PepTcell Limited. This is a rational finding of fact based on evaluation of the available evidence, including the relevant accounts, agreements and flows of money.

81. Similarly, on the evidence available to it, the FTT was fully entitled to find that the activity of making and implementing this arrangement to secure guaranteed licence fee income to meet obligations under the loans from BOS was not a trading activity (see FTT, paragraphs [76] and [83]). Such an arrangement made by persons such as Mr Vaughan, or by the Partnership, does not have the ordinary features of a trade. They are not financial traders in relevant financial instruments. The simple act of

purchasing an income stream (the guaranteed licence fees) so as to be able to repay a loan is not ordinarily to be regarded as in the nature of trade. There is nothing special about the circumstances of this case to suggest that it should nonetheless be characterised as such.

82. The FTT's findings on the facts that this financing arrangement was not itself trading activity and was separate from the trading activity relating to PepTcell Limited are sufficient to justify the FTT's conclusion that the expenditure of the Partnership attributable to that financing arrangement was not "qualifying expenditure" within sections 437(1) and 439(1) of CAA 2001. The £86 million expenditure in relation to that financing arrangement was to produce guaranteed licence fees, not research and development. The FTT was therefore entitled to conclude that it was not expenditure "on" research and development.

83. Furthermore, the FTT found that the partners considered that the "commerciality" of their investment into the Partnership was entirely based on the availability of sideways loss relief (FTT, paragraph [62]). In this regard, the FTT was entitled to rely upon and make inferences from the Memorandum, as it did. The Memorandum was shown to potential investors (FTT, paragraph [6]). In light of the Memorandum, the FTT was entitled to find – notwithstanding its acknowledgment that there was a reasonable expectation of profits in the form of the royalties payable by PepTcell limited under the Licence Agreement (FTT, paragraph [82]) – that the prospect of such profits was relatively remote with the result that "The commerciality of the investment to an investor … did not depend in practical terms to any extent on the possible returns from those royalties" (FTT, paragraph [67]). Put another way, it was not the prospect of royalties which was the true motivation for investment in the

Scheme, but rather the availability of sideways loss relief. This analysis provides further support for the FTT's conclusion that no part of the Partnership's expenditure of £86 million on the guaranteed licence fee was properly to be regarded as expenditure on research and development.

84. To conclude, therefore, on the quantum issue, in our judgment the FTT was entitled to embark on the fact finding exercise it did to ascertain which amounts comprising the £193 million payable under the Research Agreement were expended on research and development for the purposes of the CAA 2001; it was entitled to find that the element of about £86 million attributable to Numology Limited's contribution to the Partnership was not expenditure on research and development; it was also entitled to find that the further element of about £86 million to fund the guaranteed licence fees was not expenditure on research and development; and it was entitled to find that, on a practical commercial approach, it was only the element of about £14 million left after deducting certain fees (see FTT, paragraph [65]) from the remaining balance – i.e. the sum actually paid to PepTcell Limited in return for doing research and development work for the benefit of the Partnership – which was properly to be characterised as expenditure on research and development.

85. For these reasons, we dismiss the appeals of the Partnership and Mr Vaughan on the quantum issue.

The commercial basis issue

86. We turn now to the issues concerning the partners, rather than the Partnership. The main part of the decision in relation to the commercial basis issue is at FTT,

paragraphs [77]-[83].

87. The FTT lawfully held that only £14 million constitutes "qualifying expenditure" incurred by the Partnership on research and development. The partners, including Mr Vaughan, wish to obtain "sideways loss relief" under section 381 but may only do so if:-

(i) the trade was conducted on a commercial basis; and

(ii) there was a reasonable expectation of profits.

88. HMRC do not challenge the FTT's finding that there was a reasonable expectation of profits for the purposes of section 381: FTT, paragraph [82]. But they dispute the proposition that the trade was conducted on a commercial basis.

89. The FTT said this at FTT, paragraph [82]:

> "82 Were the activities of the partners of the Partnership commercial? Was there a reasonable expectation of profit at some later stage? If we keep the same focus in mind as we took when examining whether the activities were trading activities (namely with regard to the £14 million), we are also prepared to find on balance that the activities linked to the sums paid to PepTcell Limited were incurred on a commercial basis in such a way that profits could be expected to arise within a reasonable time. The accounts of the Partnership show that the Class B Limited Partners all incurred losses in the year in which the expenditure was incurred. Indeed, that was an inherent part of the Scheme. Was there on the balance of probabilities a realistic expectation of later profits within a reasonable time? We accept that in this area of commercial activity there can be significant delays between initial investment and eventual reward. And we accept that agreements were in place under which the Limited Partners would receive a share of any

> successful development of vaccines under the Scheme. We also accept that PepTcell Limited was genuinely engaged in attempting to secure a successful outcome to its activities, and that such an outcome was something that was dependent on the success of the scientific research that it was undertaking. We have no reason to question that the research and development activities of PepTcell Limited were other than genuine. Accordingly, we consider it reasonable for a profit to be expected from that investment within the scope of the test in section 381."

90. Mr Peacock defended the FTT's conclusion that the Partnership's trade was conducted on a commercial basis.

91. Mr Prosser submitted that there were "uncommercial" elements to the Partnership's trade which meant that the FTT's conclusion should be reversed. In particular, Mr Prosser said that there was no need for the involvement of Numology Limited at all and that the price payable under the Research Agreement of £193 million was wholly "uncommercial", given that PepTcell Limited was only ever going to charge £14 million under the Research Sub-Contract for the relevant research and development services. Furthermore, he pointed out that there were two late additions to the Scheme (relating to hepatitis B and rotovirus A) which the FTT found to be dictated by "pragmatic expediency" (FTT, Annex B, paragraph [31]). This was further evidence, according to Mr Prosser, of the uncommerciality of the Scheme, since the Partnership's activities thus included research and development on two vaccines which were simply included, in Mr Prosser's words, to "pump money into the Scheme".

Discussion

92. In our judgment, HMRC's cross-appeal on this issue is unsustainable. The FTT's

reasoning and factual findings in support of its conclusion that £14 million was spent as part of a trading activity and on genuine research and development carried out for the benefit of the Partnership by PepTcell Limited were reflected in its reasoning on the commercial basis issue, in particular at FTT, paragraph [82]. The FTT was entitled to conclude that these activities within the Scheme were indeed conducted on a commercial basis. The points highlighted by Mr Prosser do not indicate that the FTT erred in law in reaching this conclusion. This was a classic *Edwards v Bairstow* case in which there were potentially relevant factors on either side of the issue to which the FTT could lawfully have regard, and it was entitled to make its own evaluative judgment in the way it did to reach its conclusion.

93. As is indicated by authority, the notion of a trade "on a commercial basis" can usefully be regarded as the antithesis of a trade conducted on an "uncommercial" basis: *Wannell v Rothwell* [1996] STC 450, 461 per Robert Walker J. As Robert Walker J there observed:

> "A trade may be conducted in an uncommercial way either because the terms of trade are uncommercial (for instance, the hobby market-gardening enterprise where the prices of fruit and vegetables do not realistically reflect the overheads and variable costs of the enterprise) or because the way in which the trade is carried on is uncommercial in other respects (for instance, the hobby art gallery or antique shop where the opening hours are unpredictable and depend simply on the owner's convenience). The distinction is between the serious trader who, whatever his shortcomings in skill, experience or capital, is seriously interested in profit, and the amateur or dilettante."

94. In our view, there is nothing in the decision of the FTT to indicate that it approached this issue in an incorrect way or that it reached a perverse or irrational conclusion on the facts. As to the role played by Numology Limited, the FTT was entitled to treat the fact that the Partnership might have engaged PepTcell Limited in a form of

scheme which did not involve Numology Limited was not relevant. The question is whether the Partnership, comprising its actual partners and undertaking the particular activity under scrutiny, was doing so on a commercial basis. On the findings of the FTT, it plainly was.

95. As for the late addition of vaccines to the Scheme (hepatitis B and rotovirus A), although these additions were indeed described by the FTT as dictated by "pragmatic expediency" the FTT does not anywhere in its decision suggest that research and development relating to hepatitis B and rotovirus A were not being undertaken, nor that a proper proportion of the £14 million paid under the Research Sub-Contract was not attributable to these two late additions. The FTT was entitled to find that these additions did not make the Partnership's trade, involving exploiting the patent applications and inventions held by the Partnership, "uncommercial" in the requisite sense. There is no reason in principle why, just by reason of the "pragmatic" motivation which underpinned these late additions, the FTT was logically bound to conclude that this made the Partnership's trade "uncommercial". It was a factor, and one which the FTT noted, but the FTT was entitled to rely on a range of other factors pointing in the opposite direction, as it did, in order to reach its conclusion on the commercial basis issue.

96. As regards Mr Prosser's criticism by reference to the sum payable to Numology Limited under the Research Agreement (£193 million), it is important to recall that on the FTT's analysis it was only £14 million of that which was actually spent on trading activity, in the form of funding and monitoring the research and development work to be conducted by PepTcell Limited using the Algorithm, for the benefit of the Partnership (see FTT, paragraph [76]). The question is whether that trading activity

was conducted on a commercial basis. The FTT found that PepTcell Limited's research and development activities, conducted for the benefit of the Partnership, were genuine (FTT, paragraph [82]). The deemed cost of the research and development recorded in the contractual documentation, at £193 million, was given by reference to the supposed position of what the research and development would have cost if the methodical or traditional method of testing had been used. Numology Limited and PepTcell Limited both knew that PepTcell Limited "had no expectation, plan or capacity" to undertake the research and development other than by use of the Algorithm (FTT, Annex B, paragraphs [35]-[37]). The Memorandum also explained how the funding provided by the Partnership was to be spent. So the cost of £193 million was never given as or thought to be the true cost of the relevant trading activity. Although the Research Agreement was part of the mechanism by which the relevant trading activity was carried on, the FTT found on a good, sustainable basis that this activity was severable in practical commercial terms from other features of the Scheme which were also covered by the overall £193 million paid to Numology Limited under that Agreement. The parts of that overall sum which related to the non-trade, financial arrangement aspects of the Scheme (including the £86 million used for the contribution to the Partnership by Numology Limited itself, the £86 million to fund the guaranteed licence fees and the funds for the Matrix fee and other fees) thus were not part of the payment for the trading element within the Scheme, and cannot be taken to have affected (or infected) the payment terms for that trading element so as to make them uncommercial, in relation to the trading element, in the manner contended for by Mr Prosser.

97. For the reasons we have given, we dismiss HMRCs' appeal on the commercial basis issue.

The trade location issue

98. The main part of the decision which addresses this issue is FTT, paragraph [84]. However, other factual findings made by the FTT are also relevant.

99. Section 391 of ICTA 1988 restricts a taxpayer's ability to have recourse to sideways loss relief if the relevant loss arises from a trade carried on wholly outside the United Kingdom. In such a case, sideways loss relief is only available to allow set off of such loss against profits from a trade, profession or vocation carried on wholly outside the United Kingdom. Thus section 391 raises the trade location issue. HMRC contended that the Partnership's trading activity was carried on wholly outside the United Kingdom, in order to restrict the extent to which the partners would be able to make use of losses incurred in carrying on that activity by way of setting them off against other profits they made in the relevant period.

100. The FTT said this at FTT, paragraph [84]:

> "Mr Prosser put this point in issue because the Partnership was established in Jersey under Jersey law. Further, MRD Ltd, the general partner, was a Jersey company, and that company had considerable powers, including powers of attorney, to act for the limited partners in The Partnership. However, this is another question on which we need to look through The Partnership to the individual Class B Limited Partners. It was not disputed that they were all United Kingdom residents for income tax purposes. That again was an element in establishing the Scheme. And we agree with Mr Peacock that the test is whether the activities were wholly outside the United Kingdom. That being so,

> we see no difficulty in finding that, in so far as the individual partners were engaged in activities in relation to their investment to the extent that they were paid to PepTcell Ltd, those activities took place at least in part in the United Kingdom.”.

Discussion

101. In our view, the reasoning of the FTT at FTT, paragraph [84], is in error. However, in the circumstances of this case, that error is immaterial.

102. The test for when a trade is partly carried on within the United Kingdom is set out in *Mitchell v Egyptian Hotels Limited* 6 TC 542 at 550-551, per Lord Sumner. Put shortly, control, or even mere oversight, regularly exercised, of trading activities within the United Kingdom locates part of the trade within the United Kingdom.

103. Contrary to the reasoning of the FTT, so-called “transparency” of partnerships under ITTOIA 2005 is irrelevant to the trade location issue. For the purposes of that issue, the FTT should have focused on where the relevant activity of the Partnership which qualified as the carrying on of a trade (by the Partnership) was located, not on where the individual partners were located or where they carried on their affairs separately from the Partnership.

104. The research and development activity by PepTcell Limited was carried out in the United Kingdom. It was the funding and monitoring of this work which the FTT found constituted the relevant trading activity by the Partnership (FTT, paragraph [76]).

105. Mr Yates, who presented HMRCs' submissions on the trade location issue, accepted that if the proper analysis is that the Partnership's trade comprised the funding and monitoring of PepTcell Limited's research and development work, HMRC must fail in its appeal on the location issue since at least some aspects of the Partnership's activities in this regard occurred in the United Kingdom.

106. As we have held above, that is the proper analysis. Accordingly, HMRC's appeal on the trade location issue falls to be dismissed.

The interest relief issue

107. The main part of the decision dealing with this issue is FTT, paragraphs [90]-[91].

108. Section 362(1)(b) of ICTA 1988 provided, at the material time, that "interest is eligible for relief ... [as a charge on income] if it is interest on a loan to an individual to defray money applied ... in contributing money to a partnership by way of capital .. where the money contributed is used wholly for the purposes of the [partnership's] trade.". Thus section 362(1)(b) gives rise to the interest relief issue. HMRC say that Mr Vaughan is not entitled to interest relief under this provision to the extent that his borrowings were not used by the Partnership wholly for the purposes of the Partnership's trade. HMRC adopt the same position in relation to all the other individual partners.

109. The interest relief issue turns upon the FTT's resolution of the trade issue and the quantum issue. If the FTT has made sustainable findings that the Partnership engaged in non-trading activities and that the partners' contributions made out of borrowings

funded such non-trading activities, interest relief on those borrowings will not be available to the extent that they used for those non-trading activities.

110. The FTT's reasoning is to be found at paragraph 91:

> "91 In our view the arrangement for the individual Class B Limited Partners was not for them to purchase separate shares in the Partnership but to contribute capital to the Partnership. It is therefore allowable, if at all, under the conditions of section 362(1)(b). That provides allowable relief if the money contributed "is used wholly for the purposes of the trade ... carried on by the partnership." We take this to mean that where capital is contributed such that it is used in part for trading and in part for other reasons, the capital used for trading can be the basis for a claim under this section. We do not consider that the section requires that the whole of any capital contributed must be so used for any relief to be given. There was no contention in this case that any capital was recovered by any partner from the Partnership during the relevant period. Following from the above analysis we therefore find that Mr Vaughan was entitled to relief under this section only to the extent that the sums he contributed as capital to the Partnership were used for the purposes of the trade. That is, they are allowable to the extent that they were used to fund Mr Vaughan's share of the £14 million Research Sub-Contract with PepTcell Limited and incidental expenses."

111. Thus, put shortly, the FTT found that part of the borrowings was used for the purpose of funding the Partnership's trade (the proportionate amount used to fund Mr Vaughan's share of the £14 million expenditure on trading activity), whereas the balance was used for other, distinct, non-trading activities. In particular, therefore, Mr Vaughan was not entitled to interest relief in respect of the amount derived from his borrowings which funded Numology Limited's deposit of £86 million for the non-trading financing arrangement which generated the guaranteed licence fees.

112. Mr Peacock submitted that the FTT was wrong to restrict Mr Vaughan's interest relief to those borrowings attributable to the cost of funding and monitoring the research and development undertaken by PepTcell Limited. Mr Peacock submitted that some (indeed all) of Mr Vaughan's borrowings (not just those in respect of the £14 million funding in relation to PepTcell Limited) must be attributable to obtaining royalties from PepTcell Limited, from which it followed that the whole of those borrowings were used by the Partnership wholly for the purposes of its trade. All the sums derived from Mr Vaughan's borrowing were contributed to the Partnership and paid to Numology Limited under the Research Agreement so as, in effect, to acquire a right to future royalties under the Licence Agreement, and such acquisition of royalties was part of the Partnership's trade.

Discussion

113. The FTT made sustainable findings of fact on the trade issue and the quantum issue to the effect that the Partnership's trading activities were restricted to the funding (to the extent of £14 million) of PepTcell Limited's research and development work and the monitoring of that work. The FTT also made a sustainable finding of fact that the funding of the guaranteed licence fees was not a trading activity.

114. On proper analysis, therefore, the partners' borrowings funded a trading activity (in relation to PepTcell Limited's research and development: FTT, paragraph [76]), but also funded the deposit for the guaranteed licence fees, which was not part of a trading activity (FTT, paragraphs [64]-[68] and [76]). The FTT also made sustainable findings that the commercial basis for the partners' investment in the Scheme did not depend on the possible returns from the royalties (FTT, paragraph

[62]). The FTT was entitled to find that it was only £14 million out of the overall financing which was spent on the Partnership's trading activity.

115. In the light of these findings, which cannot be impugned, the FTT was also clearly entitled to find that the interest relief available to Mr Vaughan should be restricted to the proportionate part of his borrowings which was used to fund the £14 million spent on the Partnership's trading activity.

116. For these reasons, we dismiss Mr Vaughan's appeal on the interest relief issue.

The fee deductibility issue

117. The main part of the decision dealing with this issue is FTT, paragraphs [85]-[89].

118. The Matrix fee is only deductible from the Partnership's trading profits if the Partnership expended that fee "wholly and exclusively" for the purposes of the Partnership's trade: section 34(1)(a) of ITTOIA 2005.

119. The FTT said this at FTT, paragraph [89]:

> "89 We find from this that a single "one-off fee" was payable and was paid for services to be provided for at least 5 years and potentially for 15 years. The amount was related entirely and only to the amount of capital being introduced by the Class B Limited Partners (in other words, to the actual capital being introduced to the Scheme). We have already established that we do not consider that the full amount of that introduced capital was expended on research and development or was properly regarded as used for trading activities. Accordingly, we do not consider that the one-off fee payable in respect of each Class B Limited Partner can be regarded as being expended wholly and exclusively for the purposes of a trade. Nor do we consider that we

> have been offered any evidence that persuades us that the sum is severable. Accordingly, the sum is not deductible. Alternatively, the sum could be regarded as a capital sum by reference to the basis on which it is calculated, to the period for which it is paid and the time at which it was payable and paid. On either analysis no part of the sum is in our view deductible under section 74(1)(a) of the 1998 Act as it was not in fact "money wholly and exclusively laid out or expended for the purposes of the trade"."

120. The FTT found as a fact that the Matrix fee related to services provided by MSF which related partly to the trade and partly to activities (in particular the arrangements to secure the guaranteed licence fees) which were not in the character of trading activity. It concluded, therefore, that whole of the Matrix fee was non-deductible under section 34(1)(a).

121. Mr Prosser submitted that the operation of the "wholly and exclusively test" in that provision is well known. If there is a duality of purpose for payment of a particular sum, partly for trade and partly for non-trade activities, as the FTT found to be the case here, that is fatal to an entitlement to make a deduction under section 34(1)(a).

122. Mr Peacock suggested that, as a matter of authority, an apportionment is possible. He relied upon *Copeman v Flood* [1941] 1 KB 202. Mr Peacock submitted that we should remit the case to the FTT to make findings as to the apportionment of the Matrix fee between trade and non-trade purposes.

Discussion

123. In our view, Mr Peacock's submission is unsustainable. We consider that Mr Prosser's submission is plainly correct.

124. *Copeman v Flood* does not support the taxpayer's argument on this issue. The decision in that case was to remit a matter to the relevant fact-finding tribunal (the Special Commissioners) so that they might find whether and to what extent an element of directors' remuneration was "wholly and exclusively" incurred for the purposes of the payer's trade. The tribunal was to examine whether it was possible to divide up and separate out the elements contained within the remuneration in question, and then to see in relation to any individual element whether it could be said to have been spent wholly and exclusively for the purposes of the relevant trade. It is not an authority that an apportionment should be made if no separation of a payment into discrete elements is possible on the facts..

125. In the present case, by contrast, the FTT concluded that the Matrix fee related to the entirety of the Scheme and could not be sub-divided into discrete elements attributable to different aspects of the Scheme. The FTT found that it was not "severable" (FTT, paragraph [89]). This was a view which it was plainly entitled to take on the evidence. Indeed, we think it would have been difficult for any other view to be taken. The FTT found that the Partnership engaged in both trade and non-trade activities and that the Matrix fee was attributable to both. Therefore, the "wholly and exclusively" test in section 34(1)(a) could not be satisfied by the Partnership. We consider that this conclusion is unassailable.

126. For these reasons, we dismiss the Partnership's appeal on the fee deductibility issue.

<u>Conclusion</u>

127. All of the taxpayer appeals and all of the HMRC cross-appeals are dismissed.

Mr Justice Sales

Judge Julian Ghosh QC

Released: 2 September 2014