Building blocks of tax

Elizabeth Small discusses the grounds the Supreme Court considered to dismiss Centrica's appeal.

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UK tax legislation is voluminous with many intricate and well-hidden bear traps for the unwary, but the case of *Centrica* reminds us that it is important to understand the fundamental building blocks of the UK tax system. One of those blocks in my opinion is the vital distinction between 'capital' and 'revenue' expenditure. (An analogous issue that is sometimes overlooked is whether an asset is held as an investment or as trading stock but that is for another article.)

In *Centrica*, the Supreme Court had to decide whether the fees incurred in respect of a sale of assets were 'expenses of a capital nature' and thus excluded from deduction as management expenses of an investment business.

Spoiler alert: the Supreme Court unanimously dismissed the taxpayer's appeal, holding that the expenditure was capital in nature.

Background

Centrica Overseas Holdings Ltd (COHL) (an intermediary holding company in Centrica plc, a multinational group supplying energy to UK and European customers) had, in July 2005, acquired a Dutch company, Oxxio BV (Oxxio), with four subsidiaries.

The investment in Oxxio, together with other European investments, proved unsuccessful and generated significant losses. On 1 June 2011, the Centrica group completed the sale of the trade and assets of Oxxio, which resulted in a loss on disposal of £56m. This was part of a wider shift in business operations as noted in a press release regarding Centrica PLC's results for the year ended 31 December 2011: 'The European segment was classified as a discontinued operation during 2009 following the Group's decision to dispose of its 100% interests in Segebel SA (Segebel), Centrica Energía SL (Centrica Energía) in Spain and Oxxio BV (Oxxio) in The Netherlands. The disposal of Segebel was completed in 2009. The sale of Centrica Energía was completed in November 2010.'

The Supreme Court noted that Centrica PLC's accounts for 2009 stated that management had 'approved and initiated a plan to sell [the Oxxio business] in the Netherlands', and that a board minute dated 28 July 2009 recorded that Oxxio and two other European businesses 'would be treated as discontinued businesses held for sale'. As the FTT noted, 'held for sale' is an accounting term defined by IFRS5 (International Financial Reporting Standard 5 which deals with non-current assets held for sale and discontinued operations).

By June 2010, Eneco Group NV (Eneco) had been identified as a potential purchaser and a virtual data room had been set up with the purpose of providing information to Eneco. As noted by the Supreme Court at para 41: 'Eneco first made an indicative offer in September 2010, which was rejected. There may have been another offer, which was also rejected in December 2010. In January 2011 Eneco made a final offer, which formed the basis of subsequent negotiations and the eventual sale. At that stage, many parts of the deal remained to be negotiated and there was still a high risk that the deal would fail.'

COHL is (and was at the relevant times) an investment holding company, providing funding to the group's overseas entities. Its balance sheet shows significant investments in subsidiaries. The Supreme Court elaborated on this point in an opening paragraph of the judgment stating that:

Key points

- In *Centrica*, the Supreme Court had to decide whether the fees incurred in respect of a sale of assets were 'expenses of a capital nature'.
- Consider capital versus revenue expenditure.
- The Supreme Court considered the cases of *Sun Life Assurance Society v Davidson* and *Camas plc v Atkinson*.
- The Supreme Court dismissed the taxpayer's appeal, holding that the expenditure was capital in nature.

> 'The principal activity of an investment holding company, whether the "topco" of a group or an intermediate holding company, is to hold investments. Its investments are capital investments held in its subsidiaries for the purposes of long-term investment, from which it derives value. Its investment business is the holding of shares and the arrangement of the affairs of its subsidiaries which that holding enables, including the disposal and acquisition of companies, the general control of the subsidiaries to ensure their value is maintained, and the bringing in of income in the form of dividends from those subsidiaries. In other words, its business is to manage its capital assets, not to trade with them.'

The sale of the Oxxio business involved a complex and lengthy negotiation and eventually was achieved by way of sale of the assets of two of the Oxxio subsidiaries and the shares in a third subsidiary to Eneco. Professional fees totalling £2,529,697 (the disputed expenditure) were paid to Deutsche Bank AG London (Deutsche Bank), PricewaterhouseCoopers and De Brauw Blackstone Westbroek, for services ranging from considering how best to realise value from the Oxxio business to advising on structuring and preparing the details of the final transaction.

COHL claimed relief for the disputed expenditure in its tax return for the accounting period ending 31 December 2011. Although the vast majority of the disputed expenditure related to the Deutsche Bank fee which was in two parts: a fixed amount of £2.5m if the Oxxio transaction completed and an additional incentivisation fee for which COHL did not claim a deduction, COHL never drew a distinction between the fees and so the whole claim either stood or fell as one.

COHL's claim for relief did not extend to cover its expenditure on fees for professional services during the period post-dating 22 February 2011 (the date of the board meeting approving the sale price) because it accepted that those fees were expenses of implementation of the transaction and as such, could not be severed from the disposal.

HMRC denied the claim for the disputed expenditure on the basis that:

- the disputed expenditure was not deductible because it was not an expense of management; and
- in the alternative, even if the disputed expenditure was an expense of management, it was capital in nature.

By the time the case reached the Supreme Court the only question was whether the disputed expenditure was capital in nature, but the decisions made along the way were more nuanced.

The First-tier Tribunal (FTT) had dismissed COHL's appeal on the basis that the disputed expenditure was not incurred by COHL. However, in respect of the capital expenditure question, the FTT found that some of the disputed expenditure was revenue expenditure and would have been deductible, whilst some was capital expenditure and not deductible. COHL appealed to the Upper Tribunal, which allowed the appeal, finding that all of the disputed expenditure was expenses of management of COHL and revenue expenditure, and therefore deductible. HMRC appealed to the Court of Appeal, which found that the disputed expenditure was expenses of management, but allowed HMRC's appeal on the basis that the disputed expenditure was capital in nature and therefore not deductible.

The technical issue

All investment companies such as COHL claim a tax deduction for expenses under CTA 2009, s 1219 which enables a company with an investment business to deduct the expenses of management of that business in calculating its profits for the purpose of determining its liability to corporation tax. However, a crucial limitation on the deductibility of relevant expenditure is found in s 1219(3): 'no deduction is allowed under this section *for expenses of a capital nature*' (italic emphasis added).

Investment companies are not disadvantaged as trading companies face a similar rule under CTA 2009, s 53 which provides that: 'in calculating the profits of a trade, no deduction is allowed for *items of* a capital nature' (italic emphasis added).

COHL appealed to the Supreme Court on (at the risk of simplification) two grounds:

1) it was wrong to conflate/identify what is capital for s 1219 (management expenses) by reference to s 53 (trading deductions); and
2) the Court of Appeal failed to notice that the FTT had, as findings of primary fact, identified the disputed expenditure as revenue.

COHL argued that the disputed expenditure was not capital in nature because in essence that term should be limited to the acquisition cost of the actual asset, which in this case was the shares in the relevant target company and incidental costs of expenditure. Furthermore, by definition, an investment business is very different from a trading business and thus the capital/revenue analysis will be different. And finally, the FTT had ruled on this point already.

"By the time the case reached the Supreme Court the only question was whether the disputed expenditure was capital in nature, but the decisions made along the way were more nuanced."

The Supreme Court

The unanimous Supreme Court decision was given by Lady Simler who rapidly dismissed both grounds and clearly stated:

> 'The phrase "expenses of a capital nature" in s 1219(3)(a) of the 2009 Act has the same meaning as "items of a capital nature" in section 53(1) of the same Act, and the well-established principles applicable to distinguishing between capital and revenue expenditure in the context of trading companies apply equally in this context. Further, the question whether expenditure is capital or revenue in nature is a question of law' (para 12 as expanded in para 53–61).

The Supreme Court agreed that 'day-to-day costs of staff dealing with the business of management, rents, administration costs and repairs are all deductible revenue expenses of management, and not capital in nature' and these were to be contrasted with the fees that were incurred after the commercial decision to sell the Oxxio business (a capital asset) was taken. Although different options were considered and the transaction may not have completed, those factors did not alter the commercial reality that a decision to dispose of Oxxio had been taken. The disputed expenditure was beyond normal advice to management regarding appraisals of acquisitions, disposals or restructuring. The Supreme Court saw a distinction between a holding company which is 'constantly concerned with the management of its investments, taking decisions in relation to the group, none of which is directed to buying or selling companies or assets held by companies within the group. All that is the revenue activity of an investment holding company', and fees incurred after it decides that it might buy or sell a subsidiary (para 58).

> "Whether something is revenue or capital is a question of law and case law has established that 'there is no single test or criterion which will be decisive in all factual circumstances'."

Whether something is revenue or capital is a question of law and case law has established that 'there is no single test or criterion which will be decisive in all factual circumstances' (para 63) but there are useful indications and reference was made to 'an enduring benefit' (Viscount Cave LC in *Atherton v British Insulated and Helsby Cables* [1926] AC 205, 213–214). The Supreme Court also referenced the classic three question objective test of Lord Wilberforce:

1) What was the nature of the payment?
2) What was the payment for?
3) How was the item/service for which the payment was made going to be used?

Drawing the threads together it concluded that, generally, if a capital asset is obtained the starting point is to assume that the money spent on its purchase or sale will be capital in nature (although there may be other factors). 'Where money is spent on improving an asset, or making it more advantageous, that a payment is recurring may indicate that it is expenditure on maintenance or upkeep and therefore of a revenue nature, whereas a lump sum payment may indicate the opposite' (para 75).

Because 'the question whether expenditure is of a capital nature is a question of law, the Court of Appeal (and indeed this court) can and should arrive at its own conclusion on the capital expenditure issue, applying the findings of fact made by the FTT' (para 79). Applying the three question approach the answers would be:

1) there was an identifiable capital asset – the Oxxio business;
2) the three firms were engaged specifically for this process, there was no evidence to show that they were more generally involved in advising COHL or that the disputed expenditure was recurring;
3) after considering the terms of the relevant engagement letters 'the clear objective purpose of the disputed expenditure was to assist in bringing about the disposal of an identifiable capital asset, namely the Oxxio business, in whatever form that transaction ultimately took.'

The expenditure was held to be capital in nature and the appeal by COHL was dismissed.

Conclusion

Two cases were considered in detail by the Supreme Court: *Sun Life Assurance Society v Davidson (Inspector of Taxes)* [1958] AC 184 (*Sun Life*) and *Camas plc v Atkinson* [2003] STC 968 (*Camas*).

The principle drawn from *Sun Life* was 'which costs in addition to the actual purchase price comprised acquisition costs and were not expenses of management and which costs were not to be treated as an "integral part" of the costs of acquisition and so could be deducted' (para 23), while *Camas* held that the question to be determined was whether the expenditure was 'rendered to enable Camas to reach a decision as to whether or not to make an acquisition and was therefore necessary and payable regardless of whether the purchase took place' (para 43), therefore being an expense of management and not part of the cost of acquisition.

So far so similar to the position in this appeal (para 27). Together with Lord Wilberforce's three questions, these principles help to draw the border between revenue and capital; ie once a firm decision has been taken to sell and that is reflected in board minutes and accounting treatment, then that expenditure is integral to the sale process and will not be allowable.

Author details

Elizabeth Small is corporate tax partner at Forsters. She has particular expertise in commercial and residential property transactions and can be contacted by telephone: 0207 863 8380 or by email: elizabeth.small@forsters.co.uk.

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