

## MCashback - The Final Verdict

### Introduction

On 11 May 2011, the House of Lords gave its judgement in the case of HM Revenue & Customs (HMRC) -v- Tower MCashback LLP1 and another. The Court of Appeal had previously found in favour of the taxpayer and HMRC appealed to the House of Lords against that judgement. Whilst the case revolved around a tax scheme involving expenditure on software rights, it has much wider ramifications because of two major points of issue. One was a procedural issue, concerning the restrictive effect of closure notices, whilst the other was a substantive issue, concerning whether expenditure had actually been incurred. The judgement of the House of Lords on both these issues will have far reaching consequences for future tax disputes, especially when avoidance is involved.

### Background to the case

The case before the House of Lords was concerned with claims for first year allowances (FYAs) under the Capital Allowances Act 2001 (CAA 2001) in respect of expenditure on software rights. The claims were made by two limited liability partnerships, Tower MCashback 1 LLP (LLP1) and Tower MCashback 2 LLP (LLP2). The claim for FYAs by LLP1 was made for the 2003/04 tax year and the claim by LLP2 was made for the 2004/05 tax year.

The Special Commissioner in 2008 decided in favour of HMRC on both the procedural issue and the substantive issue (which we will now refer to as the expenditure issue, to align the terminology with statements made by the higher courts). The taxpayers appealed and later in 2008, Henderson J at the High Court allowed the taxpayers' appeal on both the procedural issue and the expenditure issue. HMRC then appealed to the Court of Appeal in 2010 on both the procedural issue and the expenditure issue. The majority (Scott Baker and Moses LJ) reversed Henderson J on the procedural issue, but agreed with him on the expenditure issue. Arden LJ agreed with Henderson J on both issues. HMRC, therefore, sought leave to appeal to the House of Lords on the expenditure issue and the taxpayers cross-appealed on the procedural issue.

### The procedural issue (closure notices)

After some pressure from the taxpayers' accountants, the HMRC inspector issued closure notices for LLP1 and LLP2 dated 20 June 2006 — earlier than he would have liked. The closure notices for both LLPs were substantially the same and the one for LLP2 included the following statement:

"I have now concluded my enquiries into the Partnership Tax Return for the year ended 5 April 2005. As previously indicated, my conclusion is: The claim for relief under Section 45 CAA 2001 is excessive.

The partnership return for the year ended 5 April 2005 is amended as follows:

Capital allowances £Nil.

Allowable loss £Nil."

The "previously indicated" within the closure notice refers to the letter dated 19 June 2006 that HMRC had sent to the taxpayers' accountants that was concerned solely with Section 45(4) and the fact that expenditure does not attract FYAs "if the person incurring it does so with a view to granting to another person a right to use or otherwise deal with any of the software in question." It could, therefore, be said that HMRC were basing the closure notice on one single reason for refusing to grant the allowances. HMRC then introduced other reasons before the Special Commissioner for denying FYAs that were not mentioned in the notices.

At the House of Lords, Lord Walker agreed with the line of reasoning adopted by Moses LJ at the Court of Appeal. Moses LJ reached the conclusion that HMRC was not restricted by the contents of the closure notice and gave his reasons as follows:

"I agree with Henderson J that the fact that the taxpayers had pressed the inspector to issue the closure notice had no relevance to the identification of the subject matter of the appeal. It was, as he remarked, open to the inspector to delay until he had considered, for example, the business plan. He chose not to do so. But the fact that the inspector had indicated that there might have been other issues that arose was relevant to the exercise of the special commissioner's case management powers. The taxpayer was not deprived of an opportunity fairly to marshal evidence as to the other grounds subsequently advanced by the Revenue on the appeal."

Lord Walker then made it clear that HMRC should not draft every closure notice that they issue in wide and uninformative terms, just so that they can introduce additional issues at a later date if the matter goes to appeal.

### The expenditure issue

It was common ground that the purchase of the software rights by LLP1 and LLP2 was part of a composite transaction. HMRC argued that the overall effect of the single composite transaction from LLP2s point of view is that the highly uncommercial loan (equivalent to 75% of the purchase price) reduced the cost to LLP2 of the software, with the result that LLP2 did not incur expenditure equivalent to the full purchase price for the purposes of CAA 2001. The argument of the taxpayers was that the LLPs have plainly satisfied the statutory tests within CAA 2001 for deciding whether capital expenditure has been incurred and therefore, FYAs should be given based on the full price paid for the software rights.

The taxpayers in the MCashback case relied heavily on the decision by the House of Lords in Barclays Mercantile Business Finance Ltd. -v- Mawson (2005), referred to later as BMBF. On the other hand, HMRC argued that the MCashback scheme involved fundamentally different issues to those decided in BMBF and that case did not overrule the decision by the House of Lords in the case of Ensign Tankers (Leasing) Ltd. -v- Stokes (1992), which went against the taxpayer. These are the two cases that Lord Walker reviewed in most detail in reaching his decision in the MCashback case.

In common with the Special Commissioner, the House of Lords were concerned with the potentially excessive valuation that had been put on the software rights. Also, it was noted that various errors and mistakes were made in the documentation detailing the scheme, which seemed to cause little, or no concern to the participants.

Whilst agreeing with Henderson J that market value was not determinative, Lord Walker considered that the Special Commissioner was correct to express his scepticism about the valuation of the software rights and the commercial soundness of the transactions.

Lord Walker then went on to distinguish the MCashback scheme from the facts in the BMBF case and the Ensign case. His comments can be summarised as follows. In the BMBF case, the money went round in a loop, but the finance was on commercial terms and real expenditure had been incurred. In the Ensign case, there was not really a loan at all. In the MCashback scheme, there was a loan, but the borrowed money was not spent on the acquisition of software rights. It went into a loop in order to enable the LLPs to indulge in a tax avoidance scheme, where the capital allowances claimed are four times as high as the contributions made by the investors.

The judgement of Lord Walker was, therefore, that the conclusions and amendments in the closure notices be amended to allow 25% only of the FYAs claimed. In fact, Lord

Walker thought that was generous to the LLPs, since about one-third of their contribution was incurred on fees and expenses. He then went on, however, to say it was a “fair outcome in a confusing case.” This was the unanimous verdict of the House of Lords.

### Summary and conclusions

On the procedural issue, Lord Walker made it clear that HMRC are under an obligation to make the contents of a closure notice as clear as possible, in order that the taxpayer is fully aware of the case against him. It is not permissible for the HMRC to issue a closure notice that is so vague that anything else that they think of at a later date can then be introduced at appeal.

It is not essential, however, that HMRC detail out all their reasons for coming to a conclusion on a certain issue, especially if the matter is complicated. In the MCashback case, HMRC would have preferred to have had more time to consider the facts, but were pressured into issuing the closure notices based on the inspector’s findings at that time. Therefore, as the closure notice involved capital allowances under CAA 2001 for expenditure on software rights, HMRC were not restricted from introducing reasons for rejecting the claims at appeal that were not stated in the closure notices. HMRC would, however, have been prevented from introducing other matters, for example, the disallowance of finance charges as a revenue expense.

On the second issue, the House of Lords also made it clear that their decision did not represent a change to case law. The previous cases of BMBF and Ensign were still valid and Lord Walker differentiated them from the MCashback scheme. Whilst both BMBF and Ensign involved financial arrangements that were circular in nature, there was actual expenditure incurred in the former but not in the latter. The MCashback scheme was aligned more closely with Ensign. Not so much for the reason that the expenditure was not real due to the nature of the loan finance, but because the excessive and non-commercial valuation of the software rights made the expenditure unrealistic.

For further advice concerning any of the issues raised, please contact one of our key individuals detailed below, or alternatively call our helpline on 0800 526262. Information on other property tax related topics can also be found on our website at <http://bankingtaxfinance.davislangdon.com>.

#### London

Paul Farey  
+44 (0)20 7061 7139  
paul.farey@  
davislangdon.com

#### Scotland

Michael Murray  
+44 (0)131 550 9473  
michael.murray@  
davislangdon.com

#### North

Christine Weaver  
+44 (0)161 819 7600  
christine.weaver@  
davislangdon.com

#### Midlands

Tim Beresford  
+44 (0)121 710 1333  
tim.beresford@  
davislangdon.com

#### South

David Rees  
+44 (0)23 8068 2801  
david.rees@  
davislangdon.com

#### Ireland

Lois Stirling  
+44 (0)28 9024 9800  
lois.stirling@  
davislangdon.com

#### Program, Cost, Consultancy

<http://bankingtaxfinance.davislangdon.com>  
[www.davislangdon.com](http://www.davislangdon.com)  
[www.aecom.com](http://www.aecom.com)

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