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Case Number: TC09351

FIRST-TIER TRIBUNAL
TAX CHAMBER

Heard in person in London

Appeal reference: TC/2017/07505
TC/2017/07341

Tonnage tax and the application of paragraphs 89-91 Schedule 22 Finance Act 2000 (as amended)

Heard on: 2-8 July 2024
Judgment date: 06 November 2024

Before

TRIBUNAL JUDGE BOWLER
MS GILL HUNTER

Between

(1) FC SHIPPING LIMITED

(2) FB SHIPPING LIMITED

Appellants

and

THE COMMISSIONERS FOR HIS MAJESTY'S REVENUE AND CUSTOMS
Respondents

Representation:

For the Appellants: Mr Julian Ghosh KC and Mr Harry Stratton of Counsel, instructed by Stephenson Harwood LLP

For the Respondents: Mr Jonathan Bremner KC, Mr Ben Elliott and Mr Edward Hellier of Counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs

DECISION

INTRODUCTION

1. At all material times the Appellants were subsidiaries of Alliance & Leicester Commercial Finance plc ("ALCF") (now known as Santander Asset Finance plc) and were engaged in the activity of lessor and financier of assets in the corporate sector. As a result of a financing structure the Appellants became the owners of five ships. They leased each ship to Fortis Finance (UK) Ltd ("Fortis Finance") pursuant to a "Head Lease". Fortis Finance has in turn sub-leased each ship to a "Sub-Lessee", which in each case is a member of the shipping group Vroon Group BV, pursuant to a "Sub-Lease".

2. The Appellants claim capital allowances in respect of their capital expenditure on the acquisition of the ships. It is common ground that the ships are "qualifying ships", which are in principle eligible for capital allowances under the tonnage tax regime in Schedule 22 of the Finance Act 2000. The only issue in dispute is whether paragraph 90(1) of that Schedule applies to prevent the Appellants from being entitled to capital allowances, because the leases have been "de-risked".

THE ASSESSMENTS / AMENDMENTS UNDER APPEAL

3. The appeals are against a series of closure notices which were issued to the Appellants on 6 April 2017.

BURDEN OF PROOF

4. The burden of proof rests with the Appellants to show that paragraph 90 of Schedule 22 does not apply so that they are entitled to the capital allowances claimed. The ordinary civil standard of the balance of probabilities applies.

EVIDENCE

5. The written evidence was contained in two hearing bundles running to more than 11,000 pages. A statement of agreed facts has been provided by the parties, but as we explain later we have made some further findings of fact. Although there are some differences in the details of the underlying lease structures neither party has placed reliance thereon.

6. The parties rely upon expert evidence from Mr Bencard for the Appellants and Mr Sutton for HMRC. Both experts also gave evidence orally and were cross-examined.

7. Those opinions have been fully considered by us. However, to the extent that the experts were expressing their opinion of the facts we have given that evidence little weight. It is for this tribunal to find the facts on the basis of the evidence apart from opinion evidence. Opinions about facts are in contrast to the experts' opinions on the matters they were instructed to consider – namely the calculation of "non-compliance risk" as addressed later in this decision. We address their evidence more fully in that respect later in the decision.

FACTS

8. We start by setting out the agreed statement of facts.

Background

9. Each Appellant is a company incorporated in England and Wales and was resident in the UK for corporation tax purposes at all material times.

10. Prior to 24 November 2011:

(1) FC Shipping Limited (the "First Appellant") was called A & L CF March (7) Limited; and

(2) FB Shipping Limited (the "Second Appellant") was called A & L CF June (5) Limited.

11. Each Appellant carried on the principal activity of lessor and financier of assets in the corporate sector and, at all times when capital allowances were claimed in accordance with paragraphs 33-35 below, each Appellant was the direct subsidiary of Santander Asset Finance plc. Prior to 13 August 2010, Santander Asset Finance plc was known as Alliance & Leicester Commercial Finance plc.

12. Vroon Group B.V. is the ultimate parent company within the Vroon Group.

13. At all times when capital allowances were claimed by the Appellants in accordance with paragraphs 33-35 below:

(1) Vroon Shipping U.K. Ltd, FB Tankship II Limited, FB Tankship IV Limited, FC Tankship I Limited, and FC Tankship II Limited were all 80% indirect subsidiaries of Vroon Group B.V. and 20% indirect subsidiaries of Compton Investments Ltd; and

(2) Vroon B.V. and Vroon Tankers B.V. were both 100% indirect subsidiaries of Vroon Group B.V.

14. Compton Investments Ltd is a joint-venture partner of Vroon Group BV co-investing, indirectly, in the Sub-Lessees (as defined below) and is not connected with Vroon Group BV or the Alliance & Leicester or Santander groups.

15. The parties have agreed for the purposes of the current appeal that Fortis Bank S.A./N.V. was a direct or indirect parent company of Fortis Finance (UK) Limited.

Building Contracts and Novations

16. On 18 July 2003, Vroon B.V. (a company within the Vroon group) entered into building contracts for the construction of three vessels as purchaser, being:

(1) Hull no. 374, subsequently named "Nor'Easter";

(2) Hull no. 376, subsequently named "New England"; and

(3) Hull no. 377, subsequently named "Great Eastern" (together with the "Nor'Easter" and the "New England", the "FB Ships").

17. Similarly, on 15 March 2005, Vroon Tankers B.V. (a company within the Vroon group) entered into building contracts for the construction of two vessels as purchaser, being:

(1) Hull no. 2001, subsequently named "Iver Progress"; and

(2) Hull no. 2002, subsequently named "Iver Prosperity" (together with the "Iver Progress", the "FC Ships").

18. The FB Ships and the FC Ships (together the "Ships") were at all material times "qualifying ships" within the meaning of paragraph 19 Schedule 22. Accordingly, the company which "operates" the Ships (within the meaning of paragraph 18 Schedule 22) could, subject to other conditions being met, elect into the UK tonnage tax regime.

19. The building contracts were subsequently novated before commencement of the leasing transaction such that:

(1) the Second Appellant became the purchaser of the FB Ships (the novation for the "Nor'Easter" was dated 4 March 2005 and the novations for the "New England" and the "Great Eastern" were dated 1 April 2005); and

(2) the First Appellant became the purchaser of the FC Ships (the novations were dated 24 January 2006).

20. Pursuant to Clause 2.5 of each building contract for the FB Ships, the consideration payable to the builder under each building contract was stated to be US$27,540,000 (subject to adjustments under the building contract) of which:

(1) in the case of Nor'Easter, $11,016,000 had already been paid to the builder by Vroon B.V. (and which sum the Second Appellant was to pay to Vroon B.V., pursuant to clause 4); and

(2) in the case New England and Great Eastern, $5,508,000 had already been paid to the builder by Vroon B.V. (and which sum the Second Appellant was to pay to Vroon B.V., pursuant to clause 4).

21. Pursuant to a side letter to each Novation Agreement, the Second Appellant also paid Vroon B.V. a premium for the novation, being amounts of US$696,235.00 in respect of the "Nor'Easter", US$361,545.83 in respect of the "New England" and US$361,129.15 in respect of the "Great Eastern". Accordingly, the total acquisition price of the FB Ships (and therefore the total capital expenditure incurred by the Second Appellant on the provision of the FB Ships, subject to any price adjustments) was US$84,038,909.98.

22. Pursuant to Clause 2.5 of each building contract for the FC Ships, the consideration payable to the builder under each building contract was stated to be US$39,500,000 (subject to adjustments under the building contract), of which $7,900,000 had already been paid to the builder by Vroon Tankers B.V (and which sum the First Appellant was to pay to Vroon Tankers B.V., pursuant to clause 4). Pursuant to a side letter to each Novation Agreement, the First Appellant also paid Vroon Tankers B.V. a premium for the novation, being amounts of US$354,608.00 in respect of the "Iver Progress" and US$344,260.00 in respect of the "Iver Prosperity". Accordingly, the total acquisition price of the FC Ships (and therefore the total capital expenditure incurred by the First Appellant on the provision of the FC Ships, subject to any price adjustments) was US$79,698,868.00.

Head-Leases

23. Subsequent to the novation of the building contracts, each Appellant leased each of the Ships of which it was the purchaser to Fortis Finance (the "Intermediate Lessor") for a term of 25 years (which, provided certain conditions are met, could be terminated before the expiry of this term or extended for a further 12 months) (the "Head-Lease"). In particular:

(1) the Second Appellant entered into the Head-Lease for the "Nor'Easter" on 7 March 2005;

(2) the Second Appellant entered into the Head-Leases for the "New England" "Great Eastern" on 5 April 2005; and

(3) the First Appellant entered into the Head-Leases for the FC Ships on 27 January 2006.

24. The payments defined as "Full Recourse Liabilities" in the relevant Head-Lease were subsequently certified under recourse certificates on the following dates:

(1) New England - 1 November 2005;

(2) Great Eastern - 17 October 2005;

(3) Nor'Easter - 9 March 2005;

(4) Iver Progress - 17 January 2007; and

(5) Iver Prosperity - 30 March 2007.

25. The parties have agreed the amounts of the rental payments due under the Head-Lease for each Ship:

(1) as calculated when producing delivery cash flows for each Ship (other than the Nor'Easter, for which a delivery cash flow could not be located) on or around the delivery date of each relevant Ship; and

(2) as calculated when producing the recourse certificate for the Nor'Easter, referred to in paragraph 16 above (which the parties agree would have been similar to the rental payments set out in the Nor'Easter delivery cash flow, had it been located).

26. No reliance was placed by the parties on the schedule of figures and we therefore do not set them out here.

Head-Lease Guarantees by Fortis Bank S.A./N.V. (the "Fortis Bank Guarantee")

27. On the same date as each Head-Lease was entered into, Fortis Bank S.A./N.V., which at the time was the ultimate parent of the Intermediate Lessor, guaranteed the Intermediate Lessor's obligations in respect of the "Full Recourse Liabilities" under the Head-Lease in favour of the relevant Appellant on the following dates:

(1) New England - 5 April 2005;

(2) Great Eastern - 5 April 2005;

(3) Nor'Easter - 7 March 2005;

(4) Iver Progress - 27 January 2006; and

(5) Iver Prosperity - 27 January 2006.

Sub-Leases

28. On the same date as it entered into each Head-Lease, the Intermediate Lessor sub-leased the relevant Ship to a subsidiary company of Vroon Shipping U.K. Ltd which operated ships and was or became a tonnage tax company (the "Sub-Lessee") for a term of 25 years (which, provided certain conditions are met, could be terminated before the expiry of this term or extended for a further 12 months) (the "Sub-Lease"). In particular:

(1) the Intermediate Lessor leased the "Nor'Easter" to FB Tankship II Limited on 7 March 2005;

(2) the Intermediate Lessor leased the "New England" to FB Tankship III Limited on 5 April 2005;

(3) the Intermediate Lessor leased the "Great Eastern" to FB Tankship IV Limited on 5 April 2005;

(4) the Intermediate Lessor leased the "Iver Progress" to FC Tankship I Limited on 27 January 2006; and

(5) the Intermediate Lessor leased the "Iver Prosperity" to FC Tankship II Limited on 27 January 2006.

29. The Schedule to this Decision sets out details of the rental payments due under the Sub-Lease for each Ship:

(1) as calculated when producing delivery cash flows for each Ship (other than the Nor'Easter, for which a delivery cash flow could not be located) on or around the delivery date of each relevant Ship; and

(2) as calculated when producing the financial schedule to the Sub-Lease for the Nor'Easter, prior to the delivery date of that Ship.

30. Under paragraph 2.2 of the financial schedule to the Sub-Leases, the Sub-Lessee could, by giving notice, elect to pre-pay a proportion of the rent due under that Sub-Lease. In each case, the Sub-Lessee did subsequently elect to make a pre-payment of the "A Rental" as defined in the financial schedule to each Sub-Lease, and did make that pre-payment on or around the date of the election. In particular:

(1) FB Tankship II Limited served an A Rental prepayment notice on 7 March 2005 and instructed Fortis Bank S.A./N.V. to release the A Rental prepayment to Fortis Finance (UK) Limited on 9 March 2005. The parties have agreed for the purposes of the current appeal that the A Rental comprised approximately 50% of the total cost of the Nor'Easter (53.2% of total rents) (A Rentals = £7,949,143.50. Total Rentals = £14,942,576.72) and that the B rental comprised approximately 38.77% to 39.72% of the total cost of that Ship. (On the basis that the parties agree that the figures for Nor'Easter are similar to those of the New England and the Great Eastern Ships.) The Intermediate Lessor assigned for consideration the right to receive an amount of the "B Rental" payments due under the Sub-Lease. FB Tankship II Limited subsequently elected to make a pre-payment of US$3,500,000 of B Rental under its Sub-Lease on or around 18 December 2006. The parties have agreed for the purposes of the current appeal that the prepaid B rental also comprised approximately 12.42% to 12.69% of the total cost of the Nor'Easter. The percentages set out in this paragraph 30.1 are based on the figures for the New England and the Great Eastern Ships below, given that a delivery cash flow could not be located for the Nor'Easter.

(2) FB Tankship III Limited served an A Rental prepayment notice on Fortis Finance (UK) Limited on 31 October 2005. The A Rental comprised approximately 50% of the total cost of the New England (53.2% of total rents) (A Rentals = £8,052,732.50. Total Rentals = £15,101,359.05) and the B Rental comprised approximately 39.72% of the total cost of that Ship. The Intermediate Lessor assigned for consideration the right to receive an amount of the "B Rental" payments due under the Sub-Lease. FB Tankship III Limited subsequently elected to make a pre-payment of US$3,500,000 of B Rental under its Sub-Lease on or around 18 December 2006. The prepaid element of the B Rental comprised approximately 12.69% of the total cost of the New England.

(3) FB Tankship IV Limited served an A Rental prepayment notice on Fortis Finance (UK) Limited on 18 October 2005. The A Rental comprised approximately 50% of the total cost of the Great Eastern (53.2% of total rents) and the B Rental comprised approximately 38.77% of the total cost of that Ship. The Intermediate Lessor assigned for consideration the right to receive an amount of the "B Rental" payments due under the Sub-Lease. FB Tankship IV Limited subsequently elected to make a pre-payment of US$3,500,000 of B Rental under its Sub-Lease on or around 18 December 2006. The prepaid element of the B Rental comprised approximately 12.42% of the total cost of the Great Eastern.

(4) FC Tankship I Limited served an A Rental prepayment notice on Fortis Finance (UK) Limited on 15 January 2007. The A Rental comprised approximately 79.85% of the total cost of the Iver Progress.

(5) FC Tankship II Limited served an A Rental prepayment notice on Fortis Finance (UK) Limited on 21 March 2007. The parties have agreed for the purposes of the current appeal that the A Rental comprised approximately 79.85% of the total cost of the Iver Prosperity.

31. The Sub-Lessees entered into time charters with unrelated third parties in respect of the Ships.

Assignment of right under Sub-Lease by Intermediate Lessors to Appellants

32. As security for the sums due to the relevant Appellant under each Head-Lease, each relevant Appellant and Intermediate Lessor entered into an assignment (each referred to as a "Lessee/Lessor Assignment") under which the Intermediate Lessor assigned its right to the Sub-Lease Earnings and all other Sub-Lease Rights (each as defined in the Lessee/Lessor Assignments) with the exception of the Excluded Property (as defined in Lessee/Lessor Assignments) to the relevant Appellant and agreed that certain payments in respect of the assigned property would be made to the account of the relevant Appellant. These assignments occurred on the following dates:

(1) New England - 5 April 2005;

(2) Great Eastern - 5 April 2005;

(3) Nor'Easter - 7 March 2005;

(4) Iver Progress - 27 January 2006; and

(5) Iver Prosperity - 27 January 2006.

Capital allowances

33. The Appellants carried on the activity of ship leasing and incurred the capital expenditure mentioned above on the acquisition of the Ships for the purposes of the ship leasing activity, and the Ships belonged to the Appellants as a result of incurring that expenditure.

34. Capital allowances were claimed by the Second Appellant for accounting periods ended 30 June 2005, 30 June 2006, 30 June 2007, 30 June 2011 and 16 November 2011, and postponed in relation to the periods ended 30 June 2008, 30 June 2009 and 30 June 2010. All the accounting periods in which capital allowances were claimed are relevant to the Second Appellant's appeal except the period ended 30 June 2011 in respect of which the Respondents did not open an enquiry. The amounts of capital allowances claimed are as follows:

(1) 25.1 for the accounting period ended 30 June 2005: £1,588,618;

(2) 25.2 for the accounting period ended 30 June 2006: £9,618,056;

(3) 25.3 for the accounting period ended 30 June 2007: £8,928,212; and

(4) 25.4 for the accounting period ended 16 November 2011: £796,325.

35. Each Appellant surrendered amounts of losses resulting from capital allowances claims by way of group relief.

Enquiries by HMRC

36. The Respondents first opened enquiries into the leasing transactions on:

(1) 21 February 2007 for the Second Appellant in relation to the period ended 30 June 2005; and

(2) 25 March 2008 for the First Appellant in relation to the period ended 31 March 2006.

37. The Appellants (and their representatives and agents) corresponded with the Respondents in relation to the enquiries from February 2007 onwards.

38. On 6 April 2017, the Respondents issued closure notices amending each Appellant's tax returns to disallow the capital allowances claims and correspondingly increase its taxable profits in those accounting periods and/or reduce the amounts available for surrender as group relief.

39. On 5 May 2017, each Appellant appealed against the closure notices pursuant to paragraph 34(3) and (4) of schedule 18 to the Finance Act 1998. As part of this appeal, each Appellant requested that the Respondents review the matter in question pursuant to section 49B of the Taxes Management Act 1970.

40. On 23 August 2017, the Respondents notified each Appellant of the conclusions of its review which upheld the closure notices.

41. On 21 September 2017, each Appellant made and notified an appeal to the Tax Chamber of the First-tier Tribunal.

OUR FINDINGS OF FACT

42. In this section of the decision we make various additional findings.

43. HMRC invited us to make some particular findings of fact. Mr Ghosh submitted that the findings of fact sought by HMRC are not relevant as they focus on the purpose behind the transactions which he submits is not a relevant consideration for the purposes of the application of paragraph 90 of Schedule 22 ("paragraph 90").

44. This tribunal is primarily a fact-finding tribunal. It is therefore incumbent upon us to find facts. Mr Ghosh's submissions relate to the interpretation and application of paragraph 90 as a matter of law. We turn to this later in the decision, but it is important not least for any onward appeal that full findings of fact are made. In addition, we are of the view that many, if not all, of the findings are directly relevant to the application of paragraph 90 as we explain later.

Core Structure

45. While we recognise that a structure like this should not be overly simplified when considering the issue before us, we consider it to be helpful to set out a picture of its core elements as focussed upon by Counsel for both sides. We are grateful to both sides for the helpful ways in which the structure and issues were presented to us.

46. The core elements of the transactions in dispute can be described as follows:

(1) Subsidiaries of Vroon Group BV agreed to purchase the Ships from the shipbuilder and those purchase contracts were novated to the Appellants;

(2) the Appellants entered into Head Leases with Fortis Finance as Lessee. Its parent company, Fortis Bank S.A./N.V ("Fortis Bank"), guaranteed Fortis Finance's full recourse liabilities (identified below);

(3) Fortis Bank granted the Appellants a letter of credit to make payments on demand;

(4) Fortis Finance subleased the ships to Vroon Group BV subsidiaries - the Sub-Lessees - on leases of 25 years. (Those subsidiaries were not those which had agreed to purchase the Ships.) The Sub-lessees were within the tonnage tax regime and chartered the ships to third parties. Vroon Group BV acted as guarantor of the Subleases ("the Vroon Guarantee");

(5) under the Sub-Leases sterling annual A rentals, dollar annual B rentals and dollar quarterly C rentals were payable with an option to prepay the A Rentals;

(6) the Sub-Lessees exercised their prepayment option and prepaid more than 50% of the Sub-Lease rentals to Fortis Finance ("the Prepayments"). However, no prepayments were made by Fortis Finance under the Head-Lease. Indeed, there was no ability to do so. Furthermore, Fortis Finance did not give the Appellants any charge, pledge or undertaking in relation to the Prepayments. There was no restriction imposed by the terms of the transactions before us on the use by Fortis Finance of the Prepayment received by it;

(7) In order to make the Prepayments the Sub-Lessees borrowed from Bank of Korea and Fortis Bank Nederland NV under a loan referred to as the "Parallel Debt". The purpose of the Parallel Debt was expressly stated to be to finance the payment by the borrowers of the prepayment of A rental (and a deposit to be placed with ABN Amro Bank who was the security trustee for the financing arrangements). The Sub-Lessees undertook to use the advances under the Parallel Debt for that purpose and it was a condition of the Parallel Debt that the borrowers delivered a notice of prepayment of A rental pursuant to the Sub-Leases;

(8) Security was provided by the borrowers under the terms of the Parallel Debt in the form of mortgages over the Ships as well as Sub-lease and earnings assignments, account pledges, bank support letters, proceeds deeds, notices of assignment of insurances up and a guarantee from Vroon Group BV in favour of the security trustee, Fortis Bank (Nederland) NV;

(9) The terms of the Parallel Debt included cross default provisions.

47. We note the following additional security elements of the transactions. Although these are not elements which are at the heart of the dispute (because the parties have agreed that they do not themselves cause the rule in paragraph 90 to be invoked) they are relevant to note to give context to the levels of security arrangements for various parties in the overall financing:

(1) Fortis Finance assigned its rights to the Sub-Lease Earnings and all other Sub-Lease Rights (with the exception of the "Excluded Property" which was the A, B and C rentals) to the Lessor and agreed that certain payments in respect of the assigned property would be made to the account of the Lessor (the "Lessee/Lessor Assignment");

(2) the Sub-Lessees and Fortis Bank (Nederland) NV entered into a Sub-Lessee Assignment under which the relevant Sub-Lessee assigned its rights to certain earnings, insurances and compensation to Fortis Bank (Nederland) NV ("Sub-Lessee Assignment");

(3) the Sub-lessees also entered into earnings account pledges which were security for their obligations under the Parallel Debt. Sub-Lessee accounts were set up with Fortis Bank and the Sub-Lessees granted a first pledge over the Sub-Lessee Earnings Account to Fortis Bank (Nederland) NV;

(4) Fortis Finance agreed to open and maintain the Lessor Proceeds Account with Fortis Bank, and the Proceeds Deed provided that the lessor would procure that proceeds would be paid directly into a lessor proceeds account on sale or receipt of insurance/compensation;

(5) The Sub-Leases provided for cross default.

48. The Head Lease provided:

(1) that no advance payments were to be made under it;

(2) all amounts payable under the Head Lease were to be treated as rental payments as far as the parties were concerned. That included the Special Termination Sum described below which did not represent rentals;

(3) rental payments for the primary period of 25 years were to be in sterling payable annually;

(4) for the "Termination Sum" which was an amount payable under the Head Lease from Fortis Finance to the Appellant following the termination of each Head Lease, including following Fortis Finance's default under the Head Lease.

49. The Termination Sum has two principal components:

(1) The first component is the "Basic Termination Sum". This amount reflected a present value of the unpaid rents due under the Head Lease (discounted to reflect the time value of money). It amounted to approximately 88% of the Termination Sum, the precise proportion depending on when the Head Lease was terminated. This Basic Termination Sum was a full recourse liability, i.e. it was owed regardless of whether the Sub-Lessee paid its rent under the Sub-Lease;

(2) The second component is the "Special Termination Sum". Effectively, default under the Head Lease would lead to an additional cost to the Appellant, because the Basic Termination Sum would be received and taxed at one point in time, rather than rent payments being received and taxed over the life of the Head Lease. (The additional tax charge is also referred to in documents to which we refer below as the "strip risk".) The Special Termination Sum primarily reflected compensation for this sum. It amounted to approximately 12% of the Termination Sum, again the precise proportion depending on when the Head Lease was terminated. The Special Termination Sum was a limited recourse liability and would be owed only if the Sub-Lessee paid its rent under the Sub-Lease.

50. In his report Mr Bencard considered the interrelation of the two elements of the Termination Sum explaining that in simple terms the exposure to Vroon was about 11% of the total exposure on delivery date, rising to about 12% over a four-year period as the Basic Termination Sum amortised.

Interest in the Ships

51. The Appellants had ownership interests in the Ships which ranked behind that of financiers who had financed the Parallel Debt.

52. After that, the Sub-Lessees effectively held an economic interest in the Ships, as follows. The Head Lease and the Sub-Lease contained matching rental rebate provisions. That meant that, if the Ships were realised above a certain price, the excess would be paid to the Sub-Lessee. However, the Appellant had security in this economic interest. The result was that – if Fortis Finance or a Sub-Lessee defaulted – the Appellant had some degree of recourse to the Sub-Lessee's economic interest in the ship, albeit that this would only have any value if the ship was worth above a certain price.

Background

53. Minutes of an Alliance and Leicester wholesale banking committee meeting on 28 May 2004 describe the potential transactions with Vroon Group BV as a UK finance lease proposal with Fortis Bank London as head lessee providing direct recourse to Fortis Bank NV for the rentals. The deal was described as enabling the funding of three new tankers. The maximum contingent strip risk was approximately £7.5 million and the deal would benefit

from layered security protection. It was specifically noted that rental risk was protected by full recourse to Fortis; and strip risk was covered by Vroon.

54. Similarly, in the Alliance & Leicester consideration of the credit application for the financing, dated 4 May 2004 it was stated that:

> *"The transaction is presented as a UK finance lease under a Head Lease/Sub-Lease structure, with Fortis Bank SA/NV ("Fortis") (AA- S&P/Fitch; Aa3 Moody's) as Head Lessee, providing [Alliance & Leicester] with direct recourse to Fortis for the rentals throughout the lease term. Our exposure to Vroon UK's subsidiaries is limited to the strip risk and any additional contingent liabilities, which could result from a change in assumptions. In addition to a guarantee from Vroon B.V, we have a second ranking interest in the Vessels."*
>
> *"Head Lease Rentals are payable directly by an AA- rated financial institution. A condition of the facility will be the ratings trigger for a termination event in case Fortis or any other OECD Zone A bank acting as Lessee under this facility has a credit rating that falls below A- (negative outlook). Strip risk is covered by the guarantee of a substantial shipping group plus the value of the equity in the second priority interest in the Vessels."*
>
> *"Credit Conclusion*
> *Our primary recourse for the Head Lease rentals under this transaction is directly against an AA- rated bank and this aspect of the transaction therefore benefits from 20% risk weighting. With appropriately priced strip risk, the transaction will generate a blended ROCE of 17.5%."*
>
> *"For [Alliance & Leicester] this transaction represents a good business opportunity for an attractively priced, largely 20% weighted finance lease structure with the UK subsidiary of a long established, bona fide Dutch shipping company with an excellent market reputation. This transaction is underpinned with a robust security structure, which provides multiple layers of security."*

55. These considerations are repeated when, in June 2005, the transactions relating to the FC Ships were considered.

56. The 20% risk weighting referred to in the credit conclusion is derived from the rules under Basel I for banks' capital requirements on the basis that the loan is to a bank.

57. It was agreed by the experts that Vroon Group BV's credit rating was approximately BB. The Alliance & Leicester presentation papers show that Fortis Bank's credit rating was AA and this was a relevant factor taken into account in assessing and approving the transactions. This conclusion is also supported by Mr Bencard's analysis of Alliance & Leicester's own summary of what is described as "expected loss".

58. We find that the evidence shows, consistently with what would be expected, that the identity of the Head Lessee was of importance to Alliance & Leicester in assessing its exposure under the financing. It was seen as attractive from Alliance & Leicester's perspective to have recourse to Fortis Bank rather than to Vroon in terms of price and security. Fortis Bank and its subsidiaries were seen as a better risk than the shipping group consistent with the differing credit ratings.

59. We conclude that this shows that at least one purpose of the structure was to enable the Appellants to treat it as a bank risk rather than a shipping company risk; and that various elements were included in the structure to provide layers of security for the Appellants. There is insufficient evidence provided by the Appellants to counter this natural reading of the way in which it was presented internally.

60. Furthermore, the evidence is insufficient to show any other purpose for the Head Lease Guarantee, the Vroon Group Guarantee and the Parallel Debt/Prepayments than as layers of security in the financing for the Appellants and others involved in the transactions.

The interrelation of the transactions

61. The Head lease and Sub-Lease were entered into on the same day with terms which interrelated and relied upon each other. For example, delivery of the relevant ship in the Head Lease was defined by reference to delivery under the Sub-lease and vice versa; the head lease included as a condition precedent the Sub-lease having been duly executed; the Sub-lease recorded the purpose of the head lessee in entering into the Head Lease.

62. The Prepayments under the Sub-Lease were specifically contemplated as part of the pre-planned transaction as shown, in particular, by an email from a Vroon executive in 2004 setting out the structure, including the Prepayments which were described as a "deposit".

63. It is therefore clear not only from the descriptions in the background minutes and applications, but also the drafting of the transaction documents themselves that they were perceived by all parties as a single composite transaction. Indeed, this is not disputed by the Appellants.

Fortis Finance

64. Fortis Finance was a special purpose vehicle the only activities of which were to act as the Intermediate Lessor in the transactions. It had no other source of income.

65. The Prepayments were placed on deposit with its parent, Fortis Bank.

Capital Allowances

66. The transaction documents include clauses intended to ensure that the Appellants can claim capital allowances – for example, the Head Lease prohibits any security which would result in the application of paragraph 90.

67. In addition, it was also the case that the transaction documents required the Sub-lessee to be able to satisfy the requirements for tonnage tax to be applied.

68. As Mr Bencard confirmed in his evidence, the financing was priced on the basis that the Sub-lessees would fall within the tonnage tax regime.

The Fortis Bank Guarantee

69. Apart from guaranteeing rental payments for the use of the Ship by the lessee under the Head Lease, the Fortis Bank Guarantee also extends to various other amounts payable by the lessee including:

(1) broken funding costs, i.e. the costs of repaying funding earlier than the expected date where LIBOR had moved down (or up) from that at the start of the relevant period.

(2) Payments in respect of liabilities arising from wilful or reckless misconduct with intent to cause damage or knowledge that damage would probably result in respect of obligations under the Head Lease or any of the transaction documents;

(3) Payments in respect of representations or warranties given by Fortis Finance being incorrect in any material respect.

(4) If the Head Lease continued after the termination of the Sub-Lease amounts in respect of liabilities arising from Fortis Finance's requirements to maintain the Ship.

70. Therefore, while the Head Lease provided that all payments made by the lessee thereunder were treated by the parties as rental, we are satisfied that the terms of the documents show that the Fortis Bank Guarantee applied to amounts which would not be classified as rental (in the sense in which that term is normally used as amounts payable for the use of the Ships), such as warranty payments.

AGREED ISSUE

71. The parties have agreed that the appeals raise the following issue.

72. The sole issue is whether paragraph 90 applies such that the Appellants are not entitled to capital allowances in respect of the capital expenditure incurred by them on the acquisition of the Ships.

73. The parties agree that if (which is denied by the Appellants), for the purposes of paragraph 90, (i) the Head-Lease and the Sub-Lease together are "the lease" as defined by the legislation, (ii) the Appellant is "the lessor", (iii) the Sub-Lessee is "the lessee", (iv) the "rental payments" are the rental payments under the Sub-Lease, and (v) any other "payments under the lease" are any other payments under the Sub-Lease, then the assumption of payment obligations by the Intermediate Lessor is sufficient to remove the greater part of non-payment risk under paragraph 90.

74. At the hearing it became apparent that the Appellants were not conceding that the rental payments under the "lease" for the purposes of paragraph 90 are the rental payments under the Sublease even if it were to be concluded that the Head Lease and the Sublease together are the "lease".

THE LAW

75. Under s11 Capital Allowances Act 2001 ("CAA 2001") a person can generally claim capital allowances for capital expenditure where that person carries on a qualifying activity and incurs qualifying expenditure. Allowances are given effect for corporation tax purposes in calculating profits for a chargeable period (i.e. the accounting period of the company): s2(1)(b) and s 6(1)(b) CAA 2001.

76. Schedule 22 provides an alternative regime for calculating the profits of a shipping company for the purposes of corporation tax, referred to as the "tonnage tax regime". Broadly speaking that regime works on the basis that the tonnage tax company works out its taxable profits based on the tonnage of the ships it operates, rather than by reference to its actual business results. Companies within the tonnage tax regime are not entitled to claim capital allowances (paragraph 68 provides that a tonnage tax trade is not a qualifying activity).

77. In order to remain within the tonnage tax regime, a company must not enter into any transaction or arrangement that is an abuse of the tonnage tax regime (paragraph 41(1)). However, paragraph 41(4) provides specifically that entering into a lease is not to be regarded as an abuse of the tonnage tax regime as a result of the lessor obtaining capital allowances as a result of the lease.

78. Instead, there are specific rules dealing with leases, including finance leases, which de-risk the transactions for the lessor, found in Part X of Schedule 22.

79. Paragraph 89 of Schedule 22 ("paragraph 89") provides (so far as relevant):

> "(1) In the case of a lease of a qualifying ship within tonnage tax, the provisions of Part 2 of the Capital Allowances Act have effect subject to

> and in accordance with the provisions of paragraphs 90 and 91 (defeased leasing)…
>
> (2) In this Part of this Schedule "lease" means any arrangements that provide for a ship to be leased or otherwise made available by a person ("the lessor") to another person ("the lessee")."

80. We refer to the lease as defined under paragraph 89(2) as the "paragraph 89 lease".

81. Paragraph 90(1) restricts eligibility for capital allowances in respect of paragraph 89 leases as follows:

> "(1) The lessor under the lease is not entitled to capital allowances in respect of expenditure on the provision of the ship if—
>
> (a) the lease, or
>
> (b) any transaction or series of transaction of which the lease forms a part,
>
> makes provision the effect of which is to remove the whole, or the greater part of, any non-compliance risk which, apart from that provision, would fall directly or indirectly on the lessor."

82. Paragraph 90(2) defines "non-compliance risk" as "a risk that a loss will be sustained by any person if payments under the lease are not made in accordance with its terms".

83. Paragraph 91 Schedule 22 ("Paragraph 91") sets out what are titled "excepted forms of security" to which paragraph 90 will not apply. Those relevant to this dispute are as follows:

> "(1) Paragraph 90 (defeased leasing) is subject to the following exceptions.
>
> …
>
> (3) It does not apply to the provision of security by the lessee, or a person connected with the lessee, if the following conditions are met—
>
> (a) no deposit of money or other property by way of security is obtained by the lessor or any third party;
>
> (b) any payments under the security are limited to the amount of any rental payments under the lease in respect of which the lessee is in default.
>
> …
>
> (5) It does not apply to the provision of security by a third party if the following conditions are met—
>
> (a) no deposit of money or other property by way of security is obtained by the lessor or any third party;
>
> (b) the security does not involve the assumption of any obligations of the lessee under the lease in return for a payment made (directly or indirectly) by the lessee or a person connected with him;
>
> (c) the security does not give rise to any payments to the lessor unless the lessee defaults on the rental payments under the lease;
>
> (d) any payments under the security are limited to the amount of the rental payments in default."

84. Counsel for both parties agreed that in interpreting the legislation a purposive approach should be applied. In doing so we have applied the following principles:

(1) in applying a tax statute to a particular transaction, there are "two steps which are necessary in the application of any statutory provision: first, to decide, on a purposive construction, exactly what transaction will answer to the statutory description and

secondly, to decide whether the transaction in question does so": *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51, [2005] 1 AC 684 at [36];

(2) the court's task, within the permissible bounds of interpretation, is to give effect to Parliament's purpose (*R (Quintavalle) v secretary of State for Health* [2003] 2 AC 687 approved in *Hurstwood Properties (A) Ltd v Rossendale BC [2021] UKSC 16, [2022] A.C. 690* at [10];

(3) the notion of words having a natural meaning is not always very helpful and certainly not as a starting point, before identifying the legislative purpose and scheme (*Bloomsbury International Ltd v Department for Environment, Food and Rural Affairs* [2011] 1 WLR 1546 approved in *Rossendale* at para 10);

(4) the "transaction in question" is the transaction actually entered into, "viewed realistically": *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51, [2005] 1 AC 684 at [36], approving *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003]. It is not for the taxpayer or HMRC to "rewrite the agreement between the parties" retrospectively, in the hope of obtaining a more or less favourable tax result: *HMRC v Bluecrest Capital Management LP* [2023] EWCA Civ 1481 at [74]. However, in this case it is particularly apparent to note in this context that we should address the actual transactions in the context of the legislative definitions as we explain later;

(5) the particular charging or exempting provision must be construed in the context of the whole statutory scheme within which it is contained. The identification of its purpose may require an even wider review, extending to the history of the statutory provision or scheme and its political or social objective, to the extent that this can reliably be ascertained from admissible material (*Rossendale* at [16]);

(6) the facts must also be looked at in the round and this is not limited to situations where there is a composite scheme involving steps which have no commercial purpose (*Rossendale* at [17]).

85. Both parties have urged reliance upon the Explanatory Notes which accompanied the introduction of the tonnage tax provisions in identifying the purpose and construction of the rules and we agree that it is important in this case to do so.

86. In referring to them we have borne in mind the principles to which Mr Ghosh referred us: "Explanatory Notes, prepared under the authority of Parliament, may cast light on the meaning of particular statutory provisions... The context disclosed by such materials is relevant to assist the court to ascertain the meaning of the statute, whether or not there is ambiguity and uncertainty, and indeed may reveal ambiguity or uncertainty": R (*Project for the Registration of Children as British Citizens) v Home Secretary* [2022] UKSC 3, [2023] AC 255 at [32]. As the House of Lords said in *R (S) v Chief Constable of the South Yorkshire Police* [2004] UKHL 39 (at [4]),

> "In so far as they cast light on the setting of a statute, and the mischief at which it is aimed, they are admissible in aid of construction of the statute. After all, they may potentially contain much more immediate and valuable material than other aids regularly used by the courts, such as Law Commission Reports, Government Committee reports, Green Papers and so forth".

THE PARTIES' CASES

87. We heard extensive submissions from both parties which we have considered in full. We address specific submissions in the context of the issues in turn, but given the extent of the submissions, only summarise key points in this decision.

88. However, the context of the dispute is that HMRC say that:

(1) the application of the definition of the paragraph 89 lease means that the "lease" for those purposes is a combination of the Head Lease and Sublease, with the result that the Appellants are the "lessors" and the Sub-lessees are the "lessees";

(2) three provisions - the fact that the payment obligations under each Head Lease are borne by Fortis Finance (as the lessee under the Head Lease), rather than the Sub-Lessee; the Fortis Bank Guarantee; and the Prepayment - either individually or in combination cause the greater part of the "non-compliance risk" (as defined in paragraph 90) to be removed.

89. The Appellants say that:

(1) the paragraph 89 lease is the Head Lease alone, but even if the paragraph 89 lease is the Head Lease and Sublease, the non-compliance risk is found in the risk of non-payment of rentals under the Head Lease as that is the only payment made to the Appellants;

(2) the identity of the Intermediate Lessor is not a "provision" and therefore should not be considered under paragraph 90;

(3) the Fortis Bank Guarantee is an excepted security under paragraph 91; and

(4) the Prepayment does not remove the greater part of the non-compliance risk in the Head Lease which must be assessed by reference to the payments due to the Appellants.

DISCUSSION

Overview of the statutory scheme and its purpose

90. We recognise the following description of the basis for capital allowances:

> *"The object of granting the allowance is… to provide a tax equivalent to the normal accounting deduction from profits for the depreciation of machinery and plant used for the purposes of a trade… When the trade is finance leasing, this means that the capital expenditure should have been incurred to acquire the machinery or plant [in this case, the ships] for the purpose of leasing it in the course of the trade. In such a case, it is the lessor as owner who suffers the depreciation in the value of the plant and is therefore entitled to an allowance against the profits of his trade": Barclays Mercantile Business Finance Ltd v Mawson [2004] UKHL 51, [2005] 1 AC 684 at [39]."*

91. While companies within the tonnage tax regime are generally not entitled to claim capital allowances (para 68 Schedule 22), the ability of lessors of ships to tonnage tax companies to access capital allowances is expressly contemplated in Schedule 22 (in stating that leases are not an abuse of the regime in allowing a lessor leasing to a tonnage tax company to access capital allowances). Provisions are then included in paragraphs 89-91 to deal with lease financing, which, by its nature, accesses and shares the benefits of capital allowances available to the provider of the finance. The history of this statutory result is informative for us to determine the purpose, and in turn the interpretation, of the legislation.

92. In 1999 Lord Alexander of Weedon QC led an independent enquiry into a potential tonnage tax. It was recognised that leasing was "by far the most difficult issue in the design of the tonnage tax". The availability of capital allowances to finance lessors for ships leased to companies within the tonnage tax regime potentially increased the cost of the regime very significantly and made that cost more uncertain. However, there was concern regarding the competitiveness of the regime compared to those offered by countries such as the Netherlands if there was no possibility to access the benefit of capital allowances through finance leasing at all. The industry viewed complete abolition of capital allowances for vessels leased in the tonnage regime was too draconian. Instead, HMRC and the industry agreed the rules could be devised which would limit the allowances given to lessors on ships leased to tonnage tax companies.

93. The original provisions in paragraph 89 applied to a "finance lease" as defined, with paragraph 89 reading (so far as relevant):

> *"89(1) "In the case of a finance lease of a qualifying ship provided, directly or indirectly, to accompany within tonnage tax the provisions of Part II of the Capital Allowances Act 1990 have effect subject to and in accordance with the provisions of – paragraphs 90 and 91"*

94. Paragraph 90 was written in the same terms as the legislation considered in this appeal save for the reference to a lessor under "the finance lease" rather than under the "lease".

95. Finance lease, lessor and lessee were given the same meanings as that used in section 82A Capital Allowances Act 1990 ("s82A") which dealt with finance leases and capital allowances generally. A finance lease in s82A is defined by reference to "normal accountancy practice" as arrangements which are to be treated in the accounts of one or more of the companies involved as a finance lease or as a loan.

96. In producing the balance between the exposure to tonnage tax companies accessing capital allowances and the recognition of commercial pressures for them to be able to do so to some extent through finance leasing, provisions were introduced in paragraph 91 for what are described as "excepted forms of security". The reductions in risk as a result of those excepted securities are excluded from the application of paragraph 90 such that, in essence, what Mr Ghosh described as "normal commercial reductions in risk" for finance leasing were identified as acceptable. As he submitted, this chimes with the conclusions reached in *Barclays Mercantile*.

97. Then, in 2003, reference to finance leases was removed and the provisions in paragraph 89 instead referred to a "lease" which was defined to mean any arrangements that provide for a ship to be leased or otherwise made available by a lessor to a lessee. Furthermore, the definition of "lease" in paragraph 89 picked up the concept of "arrangements" for plant and machinery to be leased or made available to a lessee which had been found in the s82A definition of finance lease.

98. Consistent with those changes the non-abuse provision in paragraph 41 Schedule 22 was amended so that it was not just a finance lease which was not to be taken as an abuse of the tonnage tax regime, but a "lease" as defined in paragraph 89.

99. Changing the wording of paragraph 89 to refer to a "lease" rather than a "finance lease" means that the accounting limitation of the s82A CAA definition no longer applies and consequently a wider category of leasing arrangements in included.

100. The Explanatory Notes for Clause 168 stated that the amendments extended the restrictions on the amount of capital allowances that can be claimed by a lessor for

expenditure on a ship that is used for activities within the tonnage tax to a wider range of leases. The Notes went on to explain that some lessors had begun to offer long-term leases for ships that had many of the characteristics of finance leases without being finance leases in form. Such leases could be used to allow lessors to claim significantly more in capital allowances than had been intended in the tonnage tax was introduced. The new provisions therefore extended the types of leases to which the restrictions applied. (We note that the Explanatory Notes provided in the bundle were incorrect as the original Finance Bill clause was Clause 168, not 169 to which the bundle Notes referred.)

101. Consequently, when considering the history and background to the legislation we conclude that the provisions in paragraphs 89-91 were introduced as a way of limiting the exposure to the Exchequer for tonnage companies within their preferential tax regime accessing capital allowances. While it was recognised that some financing arrangements should be permitted in order to remain competitive with other countries' regimes, a line was drawn by reference to the extent of compliance risk remaining with the lessor. The restrictions were initially defined by reference to finance leases, but that category was expanded to a wider concept of "lease" as defined, due to the concern that the finance lease definition had been circumvented.

The preordained nature of the transactions

102. Before we move onto the detailed application of the Schedule 22 rules we address one point which arose in submissions.

103. In this case there was a preordained series of transactions, but this is entirely consistent with this type of financing. A series of transactions was put in place as a package in order to finance the acquisition of the Ships.

104. As we have explained, the tax benefit of the Appellants buying the Ships used by companies within the tonnage tax regime, where the Appellants could claim capital allowances, is not by itself something which Parliament has sought to prevent.

105. Furthermore, this case is not one in which HMRC are seeking to invoke the anti-abuse provisions contained in paragraph 41-42. Those provisions enable HMRC to issue a notice excluding a company or group from the tonnage tax regime where a tonnage tax company has entered into an abuse of transaction or arrangement under paragraph 41 with the result that the companies or groups tonnage tax election ceases to be in force. Instead, HMRC are seeking to rely upon provisions contained in paragraphs 89 and 90 which provide that the lessor is not entitled to capital allowances.

106. We therefore agree with Mr Ghosh that the issue is not that a series of preordained transactions has been entered into for a lease financing – instead, the issue is whether the provisions of paragraph 90 are triggered to deny capital allowances in relation to the Ships to the Appellants.

107. However, that does not mean that the findings regarding the interrelationship of the transactions are irrelevant as Mr Ghosh sought to argue. They show the context of the financing which is important in applying the purposive approach to the legislation. They also show the interactions between elements and how they elements were viewed by the parties as security, both of which are relevant to the detailed application of the legislation.

What part of the transactions entered into falls within the paragraph 89 lease?

108. Mr Ghosh submits that it is common ground that the "lessor" under the paragraph 89 lease is the Appellants. However, the Appellants are only party to the Head Leases and therefore the paragraph 89 lease should be limited thereto. In seeking to include the Sub-Leases in the paragraph 89 lease HMRC are rewriting the transactions. Reference is made to

"its terms" by the draftsman and therefore that must mean reference to actual terms. The language of paragraphs 90 and 91 already expressly tells the reader when provisions other than those in the lease may be relevant – where the provision is made in *"any transaction or series of transaction of which the lease forms a part"* (para 90(1)(b)). There is simply no need to stretch the definition of "lease" to try and catch other provisions. The reference to arrangements in paragraph 89(2) is intended to capture where a ship is made available by means other than a lease (for example, a licence). Where there is a lease, there is no need to look any further.

109. Mr Bremner submits that given the width of the provisions, including the phrase "any arrangements" and the background scheme of the legislation it is clear that the term "lease" is an intentionally broad definition which is not confined to/by the legal meaning of the term "lease".

110. With the purpose of the statutory scheme and paragraph 89 (as amended) in mind we are clear that a wide definition of "lease" has been provided in the legislation in para 89(2). It is not only something which is in the form of a lease but also "any arrangements that provide for a ship to be made available by a person ("the lessor") to another person ("the lessee")". That in itself is coloured by the words in paragraph 89(1) which state that the provisions apply to a "lease" (as defined in para 89(2)) of a qualifying ship provided, directly or indirectly to a company within tonnage tax.

111. Mr Ghosh submitted that if there is a lease there is no need to look further to identify the "lease" for the definition in paragraph 89. On that basis the Head Lease is the paragraph 89 lease. However, we do not agree with this submission because that lease would not provide a ship directly or indirectly to a company within tonnage tax. Indeed, it is fundamental to the statutory scheme with which are concerned that there is a company claiming capital allowances on the cost of the Ships and provision of those Ships directly or indirectly to the tonnage tax companies. That is the very concept which the legislation was introduced to address as we have explained. Its purpose was to address the extent to which lessors retain risk in transactions in relation to a ship which is operated by a company within the tonnage tax regime.

112. We agree with Mr Bremner that the use of the word "any" to describe "arrangements" emphasises the broad scope of the term and there is no implicit restriction that seeks to limit the term "lease" to just one transaction or contract. The legislation very clearly extends the meaning of the term "lease" beyond the ordinary meaning of the word. We also agree that the reference in the legislation to the ship being provided "directly or indirectly" to a company within the tonnage tax regime implies that the legislation envisages multiple steps between the lessor and lessee.

113. Given the width of the definition in para 89(2) and the requirement that the ship should be provided directly or indirectly to a company within tonnage tax we therefore consider that the paragraph 89 lease comprises the Head Leases and the Sub-Leases with the result that the paragraph 89 lessor is each of the Appellants and the paragraph 89 lessee is each of the Sub-Lessees.

114. One of the submissions made by Mr Ghosh in the context of submitting that the lease as defined was only the Head Lease is that in arguing that the paragraph 89 lease included the Head lease and the Sub-lease HMRC ignored the fact that the terms of the Head lease and Sublease did not mirror each other, require payments at different times and in different currencies and therefore cannot be collapsed together into one direct lease. However, we consider that the provisions in Schedule 22 do not require that. They are very widely drawn and can encompass a set of arrangements such as those involved in this case whereby a head

lease/sublease structure was used and that forms the paragraph 89 lease for the application of the provisions without in any sense collapsing those arrangements. We recognise that there are some potentially difficult issues as to what the amount of rental is when reference to that concept is made in the legislation. We address this in context later. However, we do not consider that such difficulties can displace the need for the ship to be provided directly or indirectly to the tonnage tax company.

The transactions which are subject to paragraph 90

115. The assessment of whether the deal has been de-risked under paragraph 90 requires us to consider the paragraph 89 lease"– i.e. the Head lease and Sub-lease – <u>or</u> any transaction or series of transactions of which that paragraph 89 lease forms a part.

116. Given the findings set out above, including those which show that all the transactions for entered into in contemplation of each other, we are satisfied that the entire package of transactions should be taken into account subject then to the exclusion of any excepted security under paragraph 91. Indeed, Mr Ghosh did not seek to argue otherwise in the context of a finding that the paragraph 89 lease comprises both the Head Lease and Sublease.

117. We therefore now turn to consider what elements should be left out of the assessment under paragraph 90 as excepted securities pursuant to paragraph 91.

The Excepted Forms of Security

118. The parties have disputed whether the following elements of the transactions fall within the category of excepted forms of security:

(1) The Fortis Bank guarantee; and

(2) The Vroon Group guarantee.

119. However, it was conceded by HMRC in Mr Bremner's skeleton argument, and confirmed by him during the hearing, that while it was maintained that the Vroon Guarantee is not an excepted security, it does not add anything to the analysis under paragraph 90 on its own or when added to the other provisions which HMRC say cause paragraph 90 to be applied. The experts had agreed that the Vroon Guarantee made little difference to the non-compliance risk.

120. We therefore do not need to consider the Vroon Guarantee further in this context.

The Fortis Bank Guarantee

121. Turning to the Fortis Bank Guarantee, one potential issue is whether a guarantee is a "security" as paragraph 91 applies to transactions which are the "provision of security" meeting specified criteria. Mr Ghosh recognised in his skeleton argument that as a matter of strict law a guarantee is not security because it is a personal obligation rather than a proprietary right. However, he maintains that interpreted purposefully, the phrase "provision of security" in paragraph 91 is sufficiently broad to capture a guarantee as a guarantee has a similar economic effect to the provision of security by related or third party. We have not needed to engage in this issue as Mr Bremner confirmed in the hearing that HMRC did not seek to argue that a guarantee was not a security (this view also according with the HMRC view set out in the tonnage tax manual). HMRC was content to follow the analysis put forward by Mr Ghosh such that a contractual right, making arrangements more secure, would suffice as a "security" for these purposes.

122. Mr Ghosh submits that the Fortis Bank Guarantee is an excepted security within paragraph 91 because either:

(1) paragraph 91(3) applies as it is security provided by the lessee or a person connected to the lessee where:

(a) no deposit of money is obtained by the lessor or any third party; and

(b) any payments under the Fortis Bank Guarantee are limited to the amount of any rental payments under the lease in respect of which the lessee is in default; or

(2) paragraph 91(5) applies because:

(a) it is the provision of security by a third party;

(b) no deposit of money or other property by way of security was obtained by the lessor or any third party;

(c) the security does not involve the assumption of any obligations of the lessee under the lease in return for a payment made by the lessee or person connected with him;

(d) the security does not give rise to any payments to the lessor unless the lessee defaults on the rental payments under the lease; and

(e) any payments under the security are limited to the amount of the rental payments in default.

123. Mr Bremner submits that this is wrong because:

(1) given the application of the definition of the paragraph 89 lease including both the Head Lease and Sub-Lease, the "lessee" is the relevant Sub-Lessee in the Vroon Group, so the Fortis Bank Guarantee is not provided by the "lessee" or a person connected thereto. Consequently paragraph 91(3) does not apply;

(2) a deposit of money by way of security was obtained by a third party given the Prepayment so paragraph 91(5)(a) is not satisfied;

(3) payments under the Fortis Bank Guarantee are not limited to the amount of the rental payments in default so paragraph 91(5)(d) it is not satisfied.

Paragraph 91(3)

124. Addressing paragraph 91(3) first, we have identified that the paragraph 89 lessors were the Appellants and the paragraph 89 "lessees" were the Vroon Group subsidiaries, i.e. the Sub-lessees.

125. On that basis paragraph 91(3) does not apply to the Fortis Bank Guarantee as Fortis Bank is not the paragraph 89 lessee and is not connected to the paragraph 89 lessee.

126. That then leaves the question as to whether the third party provisions in paragraph 91(5) apply, regarding which we need to address the application of sub-paragraphs (a) and (d).

The deposit condition: "no deposit of money or other property by way of security is obtained by the lessor or any third party" (Paragraph 91(5)(a))

127. The "lessor" is each of the Appellants. The Fortis Bank Guarantee is provided by a third party. The issue is then whether the Prepayments were obtained by the Appellants or any third party by way of security.

128. At the hearing Mr Bremner and Mr Ghosh made submissions regarding the extent to which the Prepayments were made "by way of security". Mr Bremner submitted that the Prepayments functioned to make the ability of each Appellant to recover monies from Fortis Finance (or Fortis Bank) more certain. He acknowledged that there is no charge over the

monies, but they had in essence been ring-fenced within Fortis Finance, a company with no other activities. Just as a guarantee is treated as security under paragraph 91 given the function which it is performing, so the Prepayments should also be viewed in reality as performing the function of security. It would be inconsistent to apply a more formalistic need for actual security in the form of a charge in the context of the Prepayments and not to a guarantee.

129. Mr Ghosh submitted that the condition is met because there is no security interest created in the Prepayments and the purpose of them was not to secure the guarantee from Fortis Bank. The Fortis Bank Guarantee did not refer to, or rely upon, the Prepayments. Instead, the purpose of the Prepayments was to de-risk the Sub-Leases between Fortis Finance and the Vroon Group subsidiaries. Within the overall transaction structure there are deposits of money for the benefit of Fortis Finance, the security trustee and export credit financiers, but they have nothing to do with the Fortis Bank Guarantee. It would be absurd if a lessee placing money on deposit in a way unrelated to the lease had this effect or else lessees would effectively be debarred from having bank accounts.

130. Mr Bremner relied upon a difference in drafting between paragraph 91(5)(a) and the remaining subparagraphs of paragraph 91(5). In 91(5)(a) the draftsman does not require the deposit to be made under the terms of the security being considered.

131. We agree with Mr Bremner that the reference to a deposit by way of security should not be limited to amounts over which there is a charge. The draftsman has chosen to refer to the deposit "by way of security" which we interpret to mean that it is necessary to ask whether the deposit is carrying out the function of security.

132. Interpreting the provision in this way addresses Mr Ghosh's concern that any lessee deposit would otherwise breach the condition. Deposits which do not operate "by way of security" would not breach the condition.

133. The participants themselves viewed numerous elements of the transactions as "security" as shown by the evidence in an email describing the transaction as "underpinned with a robust security structure, which provides multiple layers of security". Beyond the core transactions of the Head Leases and Sub-Leases of the Ships the other numerous elements are either providing the monies needed by way of loan or are providing security for one or more of the transactions. Those layers of security did not include actual charges over assets beyond mortgages over the Ships provided under the terms of the Parallel Debt. We are therefore clear that the parties viewed the structure as involving more security than simply the mortgages of the Ships.

134. Mr Ghosh also relied upon the fact that the Prepayments were required under the terms of the Parallel Debt. We have found above that service of notice of the Prepayments was a condition of the provision of funds under the Parallel Debt and the Sub-Lessees undertook to use the funds received for the Prepayments and a deposit to be held with ABN Amro. The fact that the funds made available under the Parallel Debt were to be used for the Prepayments tells us little about whether those Prepayments were made by way of security.

135. The Prepayments were made under the terms of the Sub-leases. They were not required by the Guarantee, but we agree with Mr Bremner that the drafting of paragraph 91(5)(a) does not require the deposit to be under the terms of the security being considered. In contrast, in each of the other subparagraphs of paragraph 91(5) there is an express link to the security being considered – i.e. in (b) and (c) the draughtsman states: "the security does not…" and in (d) the draftsman refers to payments made "under the security". If the deposit was to be limited to deposits made or required under the security being considered that would be easily achieved with different drafting.

136. Mr Ghosh recognised that the Prepayments were "de-risking" the Subleases and we see little basis to conclude that, consistent with this, the Prepayments were anything other than one of the layers of security in the transactions as a whole. More particularly, the Prepayments were by way of security for the Sub-lease rentals which were not received by the paragraph 89 lessor but by a third party – i.e. the Intermediate Lessor, Fortis Finance. They clearly provided security to that third party. On that basis paragraph 91(5)(a) is breached.

137. We would also note that there are other deposits in the transactions such as that placed with the security trustee, albeit that Mr Bremner placed less reliance on them. Consistently however, and for the same reasons we conclude that they are also layers of security in the overall transaction.

138. Although we do not consider this to be necessary for our decision, we also address the issue as to whether the Prepayments had the function of being paid by way of security from the Appellants' perspective given the extent of submissions on this issue.

139. We also consider that the Appellants knew that the amount represented by the Prepayments had been received by the special purpose vehicle, Fortis Finance, the subsidiary set up for this financing by a credit worthy bank, Fortis Bank (rated AA). Therefore, this provided some further security in a broad functional sense for the Appellants. We recognise that the Appellants also had the benefit of the Fortis Bank Guarantee such that even if Fortis Finance did not receive payments under the sublease, the Appellants were protected. However, the transaction, in common with many large financings, had multiple layers of security as the email described. The fact that there were other elements of security does not detract from the conclusion that the Prepayments and deposit were also by way of security.

140. The conclusion that the Prepayments were seen to have a security function for the Appellants as well as Fortis Finance reinforces our conclusions about the application of the provisions of paragraph 91(5)(a).

141. We recognise that later in this decision we conclude that the Prepayments did not reduce the non-compliance risk because there was no charge or pledge applicable to them in favour of the Appellants. That is not inconsistent with the conclusion we have reached here. We are considering two very different concepts. In the case of the application of the excepted security rule in paragraph 91 we are looking at a functional test when considering "by way of security" which is considering not only the position of the lessor but also the position of third parties. In the case of the non-compliance risk we are considering a more precisely defined concept addressing the impact for the Appellants alone under paragraph 90 as we explain later. Our view therefore is that the correct place to address Mr Ghosh's arguments regarding the legal effect of the Prepayments is the application of the non-compliance rule in paragraph 90 itself.

142. We are satisfied that our interpretation of the rules fits within the statutory framework we have described earlier. The concerns raised by Mr Ghosh about too wide an interpretation of "by way of security" under paragraph 91 are appropriately addressed by considering whether a provision breaches the boundary drawn between acceptable and unacceptable derisking of the transactions for the Appellants themselves under paragraph 90.

143. Accordingly, for all the reasons we have set out the Fortis Bank Guarantee does not meet the requirement of paragraph 91(5)(a) to be an excepted form of security.

The rental payments limitation: "any payments under the security are limited to the amount of the rental payments in default" (paragraph 91(5)(d))

144. Given the extent of submissions and the lack of authority in this area we consider it is also appropriate to consider the alternative condition which is in dispute between the parties even though the conclusion regarding paragraph 91(5)(a) excludes the Fortis Bank Guarantee from being an excepted security.

145. Mr Ghosh submits that:

(1) the Head Lease provides that all amounts payable by the lessee to the lessor under the Head Lease shall be by way of rental. He acknowledged that this does not bind the Tribunal, but submitted that it showed that the parties' intention as a matter of private law was to treat all the sums payable as rentals. Therefore the Guarantee, in guaranteeing payments under the Head Lease, was limited to the amount treated as rentals;

(2) if that provision is disregarded it is conceded that there are payments guaranteed by the Fortis Bank Guarantee which are not rental payments. However, insofar as the Fortis Bank Guarantee applies to the Basic Termination Sum (which represents the net present value of the rental payments owed by the head lessee) it would be an excepted security because by definition the Basic Termination Sum is less than the rentals due. In addition, further amounts such as the Termination Fee and the Broken Funding Costs relate to, and are calculated by reference to, the amount of rentals. They are accordingly properly treated as rentals;

(3) as the provision contained in paragraph 91(5)(d) addresses the amount of the rentals, the Fortis Bank Guarantee is an excepted security to the extent that it applies to other amounts not in excess of the amount of rental payments;

(4) each of the indemnities in the Guarantee was stated to constitute a separate and independent obligation giving rise to a separate and independent cause of action. Therefore each of the obligations is a separate provision and should be assessed as such. This would be clear if multiple guarantees had been entered into and the situation should be no different where one overall guarantee was entered into.

146. Mr Bremner submitted:

(1) it is necessary to look at the nature of a payment to determine whether it is truly rental in applying this paragraph;

(2) the amounts potentially payable under the Fortis Bank Guarantee exceed the amounts which are truly rentals as the Guarantee extends to other payments in addition;

(3) the "provision of security" by way of the Fortis Bank Guarantee refers to all of the obligations combined and those obligations should not be viewed independently as a result of the provision stating that each of the indemnities is a separate obligation;

(4) there are numerous amounts potentially payable under the Fortis Bank Guarantee which are not calculated by reference to rental payments.

147. We consider that the wording of paragraph 91(5)(d) specifically identifies that the payments under this security must be limited to the amount of the rental payments in default. We see no basis on which the plain words of "the amount of the rental payments" should be interpreted to include amounts treated as rental payments by the parties, or even amounts calculated by reference to rental payments. Mr Ghosh, unsurprisingly, did not seek to submit that payments other than actual rental payments had that nature by virtue of the clause stating that they would be treated as such by the parties.

148. It is not disputed that there is no express limitation in the Fortis Bank Guarantee limiting the amount payable thereunder to the amount of rental payments in default. Instead, the parties have been in dispute as to whether in practice such a limitation exists.

149. We recognise that if the lessee is in default in relation to payment of rental the Basic Termination Sum is payable under the Head Lease. As that is the discounted value of the future rentals it is less than the total amount of future rentals. We would note that at the time of calculating the Basic Termination Sum there is some argument that not all future rental payments are in default. However, even if the total rentals are treated as being in default we are not satisfied that it has been shown that payments under the Fortis Bank Guarantee are limited to that total amount, even recognising that the Basic Termination Sum will be less than the total outstanding rentals. Payments can cover various other circumstances as we have found in our findings of fact including payments in respect of breach of warranties. We therefore conclude that the amounts payable under the Guarantee can exceed the amount of rental in default.

150. We note that implicit in the arguments regarding the amount of rental in default is an assumption that the rental to which reference is made is that paid by Fortis Finance. While this does not alter the conclusion reached, we consider that the combination of paragraph 91(5)(c) and (d) means that the reference is to the rental paid by the "lessee" which is the paragraph 89 "lessee" and therefore the Sub-Lessees. (The same conclusion is reached under paragraph 91(3)(b) directly.) The "lessee" being the Sub-Lessees makes no difference to the conclusion however, because we have not been shown that the payments under the Fortis Bank Guarantee would be limited to the amounts of rent payable by the Sub-lessees for which they are in default.

151. Mr Ghosh submitted that the Fortis Bank Guarantee can be considered to be an excepted security insofar as it applies to rental payments or insofar as it applies to payments not in excess of the amount of rental payments. We see no basis to interpret the provision in this way. The draftsman does not use a term such as "to the extent that".

152. We also do not accept that the obligations under the Fortis Bank Guarantee should be treated as individual separate obligations for the purposes of paragraph 91(5)(d). As Mr Bremner submitted, we are required by the legislation to consider the "provision of security by a third party". The security provided by the third party, Fortis Bank is the security provided in totality by it whether as multiple obligations in one document or multiple separate documents. We see no basis to treat each obligation separately. (If the Fortis Bank Guarantee were split into multiple separate guarantees, as Mr Ghosh postulated, we would expect to aggregate them to consider the total "provision of security" by the third party.)

153. Accordingly, we conclude that the condition in paragraph 91(5)(d) it is not satisfied in relation to the Fortis Bank Guarantee.

154. We would note that our conclusions in relation to paragraph 91(5)(d) apply equally to paragraph 91(3)(b) so that the Fortis Bank Guarantee is not an excepted security whether or not the "lease" under paragraph 89 is the Head Lease and Sublease or the Head Lease alone.

Applying paragraph 90

155. HMRC submit that there are three relevant provisions (together referred to in this decision hereafter as "the Provisions") to consider for the purposes of paragraph 90:

(1) Provision 1 - the fact that the payment obligations under each Head Lease are borne by Fortis Finance (as the lessee under the Head Lease), rather than the Sub-Lessee;

(2) Provision 2 - the Fortis Bank Guarantee; and

(3) Provision 3 - the Prepayments.

156. The Appellants submit that Provision 1 is not a "provision" on first principles and we must therefore address this issue first.

Is the fact that the payment obligations under each Head Lease are borne by Fortis Finance (as the lessee under the Head Lease), rather than the Sub-Lessee a provision for the purposes of paragraph 90?

157. The Appellants say that the identity of the lessee under the Head Leases is a characteristic of the lessee, but is not a provision of the lease/Head Lease. The mere fact that a lessee is wealthy or creditworthy cannot be relevant as otherwise that would always have the effect of de-risking a lease compared to a hypothetical lease to a lessee who was not wealthy or creditworthy. It was not Parliament's intention to encourage lessors to engage preferentially with poor credit risk. A critical determinant of the risk profile of the lease is the lessee's creditworthiness. A lease to a different lessee may have a completely different risk profile. As a matter of private law the substitution of one obligor for another can take place only by novation. In this case the lessee under the Head Lease was always Fortis Finance. HMRC does not contend that the Head Lease and Sublease can be looked through in circumstances where the Head Lease and Sublease were not back-to-back, their terms did not mirror each other, and they sometimes require payments at different times and in different currencies.

158. Furthermore, Mr Ghosh submitted that the non-compliance risk can only be located in the Head Lease. The actual transactions entered into need to be respected. It was never contemplated that the Vroon subsidiaries would be lessees under the Head Leases rather than Sub- lessees.

159. Mr Bremner submitted that it is necessary to compare the actual transactions to the paragraph 89 lease and the transactions referred to in paragraph 90. By having the Head Lease/Sub-lease structure the Appellants improved their risk position by having Fortis Finance as the counterparty (which was then further improved by the Fortis Bank Guarantee and the Prepayments). There is no reason why the existence of, and identity of, the Head Lessee cannot be a relevant "provision" in the context of paragraph 90. Mr Ghosh's submission regarding the implication that HMRC's interpretation would mean all leases to more creditworthy counterparties breach paragraph 90 is misplaced because the comparison is only made in the context of the facts of the actual case and in the light of the particular arrangements. It would be different if you had entirely unconnectedly a lease from the Appellants to a particular charterer and then unrelated to that commercial arrangement, the charterer decided that to sub-charter. There would be no link in terms of the parties' commercial arrangements between the two things, but that is very different to what has happened here where the very purpose of the arrangements was for the Appellants to exchange shipping risk for the much lower bank risk.

160. We agree with Mr Bremner that paragraph 90 is not limited to the provisions of the paragraph 89 lease using the term "provisions" to mean the legally recognised provisions of a document. Instead, the paragraph applies if the paragraph 89 lease or any transaction or series of transactions of which that lease forms a part <u>makes provision</u> which has the prohibited effect on risk. We are not required to identify the provisions of particular documents, whether a lease or any other document. That limits the meaning of the word "provision" beyond its natural meaning to a narrower concept of a provision of a document. We see no basis to do so. Instead, we need to identify what provision is made by the paragraph 89 lease or transactions of which that defined lease is a part.

161. With that in mind we agree with Mr Bremner that the paragraph 89 lease (in which, as we have already concluded, the "lessor" is the Appellants and the "lessee" is each Sub-Lessee), or the transactions of which that lease formed a part, made provision for Fortis Finance to be an intermediate lessee/sub-lessor.

162. We do not agree with Mr Ghosh that this means that paragraph 90 is causing comparison to be made to a hypothetical lease to a lessee who was not wealthy or creditworthy. The exercise required by paragraph 90 is entirely restricted to the context of the actual transactions – does this paragraph 89 lease, or any transactions of which it forms a part, make provision which breaches the non-compliance risk requirements of the legislation? That is consistent with the overall purpose of the legislation described by us earlier.

163. Therefore we need to consider, in essence, whether the provision for Fortis Finance to be the lessee under the Head Lease leasing the ships from the Appellants and sub-leasing to the Appellants removes all or part of the non-compliance risk which apart from it being lessee under the Head Lease would fall on the Appellants under the paragraph 89 lease to the Sub-Lessees.

164. This leads us on to consider the concept of non-compliance risk in more detail in the context of the Provisions.

Application of the non-compliance risk test

165. The question is whether any of the Provisions alone or in combination have the effect of removing the whole, or the greater part of, any non-compliance risk which, apart from that provision, would fall directly or indirectly on the lessor.

166. Non-compliance risk is defined as "a risk that a loss will be sustained by any person if payments under the lease are not made in accordance with its terms."

167. We note that:

(1) the non-compliance risk is a risk that a loss will be sustained by <u>any</u> person if payments are not made under the lease (as defined), not just the lessor; but the non-compliance risk must fall directly or indirectly on the lessor without the provision or provisions. Therefore, in this case at least, the non-compliance risk is the risk of that loss falling on the Appellants directly or indirectly;

(2) the non-compliance risk addresses any risk of loss from non-payment under the lease and not simply non-payment of rentals.

168. So, this means that in this case we:

(1) look at the paragraph 89 lease, i.e. the arrangements under which the Ships are provided by the Appellants to the Sub-lessees and identify what is the risk of a loss being sustained by the Appellants if payments under those arrangements are not made in accordance with their terms; and then

(2) ask whether one or more of the Provisions has the effect of removing the whole or the greater part of that risk of loss which, apart from that Provision, would fall directly or indirectly on the Appellants under the paragraph 89 lease.

169. Mr Ghosh submitted that in this case the result is that the non-compliance risk being assessed is the risk of loss arising from the fact that the Appellants do not receive payment under the Head Lease. Provisions may de-risk Fortis Finance under the Sub-Lease except insofar as that itself de- risks the Appellants under the Head Lease. That conclusion is firstly based on his interpretation of "payments under the lease" referring to the actual lease to which the Appellants are party (i.e. the Head Lease). However, we have decided that the

"lease" for the purposes of paragraph 90 is not just the Head Lease, but the entire arrangements including the Sublease. In that case, Mr Ghosh submits that it remains the case that the Appellants only receive rental payments under the arrangement from Fortis Finance under the Head Lease, so the risk again comes back to a risk of Fortis Finance not making those payments. (The concession made in the statement of agreed facts and issues was made on the basis of the rental payments under the "lease" as defined being found to be the payments made by the Sub-lessees to Fortis Finance, not the payments made by Fortis Finance to the Appellants.)

170. This issue is most clearly relevant in the context of the Prepayments to which we turn later in the decision and where we make clear that we agree that the non-compliance risk for the Appellants resides in the Head Lease.

Measuring the risk - the experts' opinions

171. The experts have provided opinions as to the measurement of the non-compliance risk and the impact of the Provisions. Both experts are well qualified, albeit with different experience. Neither party sought to challenge the credibility of either expert, although Mr Bremner submitted that Mr Bencard's experience was less on point and somewhat outdated. Mr Ghosh submitted the fundamental issue is that the experts have measured different things and we agree.

172. The variety of assumptions in the expert opinions highlights quite how difficult applying this provision can be in real world circumstances. We have decided that as both parties recognised, we must first identify the correct method of assessment as a matter of law.

173. Mr Bencard has put forward two different assessments with very different conclusions. We therefore address the differences between them.

Mr Bencard's two assessments

174. Mr Bencard describes the differences between his two assessments as follows:

> *"whereas the First Assessment involves assessing the risk of payments under the Head Lease not being made and expressing that risk is a probability weighted loss, both with and in the absence of the Provisions, the Second Assessment by contrast requires me to postulate that payments under the Head Lease are not made and then assess the risk of the relevant Appellant thereby sustaining a loss, both with and in the absence of the Provisions. The Second Assessment does not take into account the probability that a counterparty will default on payment under the Head Lease."*

175. In making his First Assessment Mr Bencard says that he was instructed to assess the effect, if any, on the risk of payments not being made to the relevant Appellant under the head lease by virtue of the various Provisions. He explains that he understands that the "risk" of payments not being made means the chance or probability, in relation to each payment due under the Head Lease, that the payment will not be made thereby giving rise to a loss equal to the unpaid amount, measured as a probability-weighted loss. This was calculated on the basis, in particular, of the probability of default by a counterparty given their creditworthiness and the "loss given default" which is the loss that experience showed would arise from particular types of receivable.

176. In making his Second Assessment Mr Bencard says that he makes the following assumptions:

(1) that there has been a failure to pay a Termination Sum by Fortis Finance; and

(2) that there will be no payment from Fortis Finance because it is insolvent;

(3) payment or part payment will not be made in the event of a distribution after administration or liquidation;

(4) Fortis Bank is also insolvent and therefore cannot make any payments under the Fortis Bank Guarantee.

177. The differences between Mr Bencard's First and Second Assessments can be illustrated by his conclusion regarding the impact of Fortis Finance being lessee taken together with the Fortis Bank guarantee. He acknowledges that those provisions taken together do indeed reduce the likelihood of loss falling on the Appellants, but he maintains that they do not reduce the amount of loss which is the thing being measured under the Second Assessment because of the insolvency assumptions he has made.

178. We consider that Mr Bencard's Second Assessment makes assumptions beyond the requirements of paragraph 90 with insufficient basis to do so for the following reasons:

(1) The experts are addressing the notion of "non-compliance risk" which is specifically defined in paragraph 90(2) as the risk of a loss being sustained if payments are not made in accordance with its terms. It does not identify the type of loss; in particular, it does not identify that the loss is sustained in the way assumed by Mr Bencard's Second Assessment involving a total failure of Fortis Finance and indeed Fortis Bank to make any payment as a result of insolvency and even to go so far as to assume that there would be no distributions made in the insolvency;

(2) As Mr Ghosh recognised in the hearing, the second assessment does not address the probability of non-payment. Yet the legislation talks of "risk", and we agree with Mr Bremner that the term implies a probability;

(3) Mr Ghosh explained that the basis for Mr Bencard's Second Assessment is, in essence, that if Fortis Finance did not make a payment the Appellants would be entitled to sue for their money and avoid the loss. Loss would only be suffered if Fortis Finance was unable to pay its debts even if sued, i.e. it was insolvent and the Fortis Bank Guarantee had no worth because Fortis Bank was also insolvent. However, this is assuming loss means total loss. It takes no account of the fact that a party may suffer loss as a result of non-payment which is partial, for example because it is paid out in part on insolvency. We see no basis in the legislation to make such an assumption;

(4) We agree with Mr Ghosh that the non-compliance risk is not just a risk of non-payment. It is a risk of a loss being sustained where payments are not made under the paragraph 89 lease. However, that does not entail the additional assumptions about insolvency made by Mr Bencard's Second Assessment;

(5) The unchallenged evidence of Mr Sutton is that default rates, which are recognised to be a measure of expected risk of loss, are defined to include missed or delayed payments (where delay is more than any grace period);

(6) We would also note that Mr Bencard did address the situation in the context of his Second Assessment where non-payment led to delayed or part payment in which case the value of an insolvency distribution from a bank rather than a shipping company would need to be considered. He said that given what we know now distributions are likely to be very high and consequently the loss would be very low where the distributions came from a bank. Considering the position when the transactions were entered into his opinion was that the loss on a Fortis exposure would be 55% of the Termination Sum, whereas a reasonable expectation of loss on a Vroon

exposure would be 100%. We note this to show the significant difference made by the assumptions of insolvency with no distributions in Mr Bencard's Second Assessment. (The Appellants do not seek to rely on the alternative where insolvency distributions are made and we therefore make no further reference to it.);

(7) We also agree with Mr Bremner that one can carry out a sense check by reference to the legislation on Mr Bencard's assumptions, and in particular the assumption that a parent company guarantee adds nothing to the implicit support from a parent company. This assumption calls into question why parent company guarantees would ever need to be excepted securities under paragraph 91 as they would never remove all or the greater part of the non-compliance risk and yet we know that such guarantees were very much in the mind of the draftsman given the references to guarantees in the Explanatory Notes. Indeed, the Explanatory Notes make clear that the provisions in paragraph 91 were particularly focussed on what are described as "common arrangements for reducing risk" such as guarantees. We recognise that, as Mr Sutton accepted at the hearing, a parent company would be expected to support a failing subsidiary in the ordinary course; but we are clear that guarantees are obtained because they provide some additional security to parties, not least because the person benefitting from the guarantee would rank higher in an insolvency were the whole group to fail.

179. We therefore conclude that reliance should not be placed upon Mr Bencard's Second Assessment.

Mr Bencard's First Assessment and Mr Sutton's assessment

180. Mr Sutton has measured the risk as the probability of non-payment regardless of how much (if any) loss is expected.

181. One difference between Mr Sutton's assessment and Mr Bencard's First Assessment is that Mr Sutton has simply addressed the probability of loss whereas Mr Bencard has produced figures reached from applying probabilities of loss to the amount of the loss.

182. To illustrate the difference Mr Ghosh described the example of the toss of a coin. There is a 50% chance of it being heads or tails. That is the figure used by Mr Sutton. Mr Bencard goes on to consider the amount at stake so that he factors in whether one risks losing £1 or £1million.

183. We explored with Mr Ghosh at the hearing whether it in fact made a difference to the outcomes if one considered a percentage for the non-compliance risk including or excluding the expected loss. To take a simple example, if the probability of loss £x without a provision is 70% and the probability of loss £x with the provision is 20% the answer to whether the provision has removed the greater part of the 70% risk is the same whether you compare 70% and 20% or 70% of £x and 20% of £x. This of course assumes that £x remains the same. To the extent that £x changes then the answers produced by the two experts will change. Similarly, if £x is itself replaced with a percentage (as Mr Bencard has done) again the outcome is the same so long as that percentage is constant.

184. Indeed, we question how £x (or indeed the expected default rate) can change in the circumstances prescribed by the legislation? We interpret paragraph 90 as requiring an assessment of the risk of a loss £x being sustained by the Appellants under the paragraph 89 lease without the Provision(s) as compared to the risk of that loss £x being sustained by the Appellants under the paragraph 89 lease or the transactions prescribed by paragraph 90 with that Provision(s).

185. In practice in this case we do not need to address this point further though because the difference in outcomes resulting from the experts' opinions do not turn upon whether one considers a risk percentage in isolation, or a risk percentage applied to another percentage (or amount). In essence, both experts have concluded that Provisions 1 and 2 together (i.e. the fact that the payment obligations under each Head Lease are borne by Fortis Finance, rather than the Sub-Lessee and the Fortis Bank Guarantee) cause the greater part of the non-compliance risk to be removed, subject to one further issue which we will shortly address.

186. In relation to Provision 3 (the Prepayments), their opinions differ for more fundamentally different reasons which we address later.

187. The figures produced by Mr Sutton and Mr Bencard (under his First Assessment) for the Provisions are as follows:

	Mr Bencard	Mr Sutton
Provision 1	The same risk because Mr Bencard relies on the Fortis Bank Guarantee	26.5% to 1.3%
Provision 2	No material difference because Fortis Bank NV would not let its subsidiary fail.	1.3% to 0.6%
Provisions 1 and 2	15.3% to 0.52%	26.5% to 0.6%
Provision 3 FB Ships FC Ships *	No material reduction because there is no security over the Prepayment	 26.5% to 10.65% 26.5% to 3.2%
Provisions 1, 2 and 3	15.3% to 0.52%	26.5% to 0.6%

*Mr Sutton works on the basis of a pound for pound reduction in risk as we address further below. The prepayments were different for the two Appellants (59.8% for FC Shipping and 87.9% for FC Shipping) so the reduction in risk alters accordingly.

The starting point for the non-compliance risk calculation

188. The table shows that the experts agree that if Fortis Finance is not lessee and there is no Fortis Bank Guarantee there is a significant difference in the non-compliance risk: 15.2% as opposed to 0.52% or 26.5% to 0.6%.

189. However, Mr Ghosh submits that whether these figures breached the rule in paragraph 90 depends upon the method of calculation. He submits that:

(1) a subtraction method should be used rather than a division method. In other words to take Mr Sutton's figures, the reduction in risk is from 26.5% to 0.6%. The difference between 26.5% and 0.6% is 19.9% which is less than 50%. (The division method results in a 97.7% reduction in risk as 0.6 is 2.3% of 26.5);

(2) but if the division method is appropriate, the appropriate denominator for determining the greater part of the non-compliance risk is the amount of loss sustained assuming there is non-compliance, i.e. 100% of the Termination Sum. The appropriate numerator is the difference between the non-compliance risk without the provision

being measured (but including any permitted securities) and the actual non-compliance risk. That produces the same result as the Appellants' subtraction method.

190. On either such approach Mr Ghosh submits that the greater part of the non-compliance risk has not been reduced whichever expert's assessment is adopted. He submitted that this properly reflected the fact that it should only be in relatively rare circumstances of abuse that it is appropriate to apply the draconian consequence of taking away a lessor's entire capital allowances.

191. It was recognised in the hearing that this debate over subtraction or division is essentially a question of the starting point for the calculations. Mr Ghosh submits that the starting point must take into account the permitted reductions in risk already present in the transactions including any excepted securities.

192. However, we agree with Mr Bremner that this does not reflect the legislation as that is not carrying out what is required under paragraph 90 for the following reasons.

193. Paragraph 90 asks us to identify the non-compliance risk of the paragraph 89 lease and consider whether one of more provisions contained in that lease or transactions removes the greater part of that risk. The starting point is not a hypothetical situation with 100% risk of default. As Mr Bremner submitted, the joint expert report shows that a shipping company has a risk of default that is less than 50% whichever expert's opinion is relied upon. Consequently, the simplest finance lease between a bank and a shipping company would have a risk of default below 50%. Applying Mr Ghosh's approach would mean that there could never be provisions which would remove the greater part of the non-compliance risk as more than 50% has been removed from the start.

194. Mr Ghosh also says that allowance must be made for the excepted securities. Although we have decided that none of the Provisions is an excepted security, we consider it to be important to address this issue given that it is a matter on which he relies to adopt a different starting point under the legislation.

195. Mr Ghosh maintains that any excepted securities must be given full recognition. Therefore if excepted securities reduce the risk in a set of transactions to less than 50%, other non-excepted securities should not breach the rule in paragraph 90 and that should not be objectionable because Parliament has approved de-risking via excepted securities.

196. Mr Bremner provided examples to illustrate the issue. One such example was the following:

(1) Assume total lease rentals are £500m and the non-compliance risk is measured as 10% or £50m;

(2) There is a non-excepted security that (independently) reduces the overall non compliance risk to £24m;

(3) There is a separate excepted security that (independently) also reduces the overall non-compliance risk to £24m.

197. Applying Mr Ghosh's approach the excepted security's reduction in the non-compliance risk by more than 50% means that non-excepted securities cannot cause paragraph 90 to be applied to remove the lessor's capital allowances. HMRC, in contrast, say that the fact that the non-excepted security causes more than 50% of the non-compliance risk to be removed is itself sufficient to cause paragraph 90 to be applied. The effect of the excepted security is not factored into the paragraph 90 calculation.

198. Although we can see that there is a good argument for the approach to excepted securities advocated by Mr Ghosh, we do not consider that it is supported by the wording of the legislation.

199. As explained the starting point under paragraph 90 is the non-compliance risk of the paragraph 89 lease. There is nothing to extend that starting point to encompass the paragraph 91 excepted securities. It is then necessary to consider provisions of the lease or transactions other than those excepted under paragraph 91. This is achieved by paragraph 91 referring to the provisions by way of security which are excluded and removing those from the consideration of "provisions" removing non-compliance risk under paragraph 90. But the starting point against which the removal is measured is not extended to include the effect of the excepted securities.

Provisions 1 and 2 – Fortis Finance as Intermediate Lessor and the Fortis Bank Guarantee

200. The evidence from both experts therefore shows that the greater part of the non-compliance risk is removed for the Appellants as a result of Provisions 1 and 2.

201. Given the difficulties with the interpretation of this legislation we have considered this conclusion in the context of the purpose of the legislation identified by us earlier. We consider that, in effect, replacing the risk of a deal with a shipping company within the tonnage tax regime with the risk of a deal with a bank clearly reduces the non-compliance risk to which the Appellants were exposed. Indeed, that was the basis of entering into the transactions as shown by our findings earlier. Given the boundary drawn by Parliament in the legislation and the history of that legislation which we have addressed earlier, we are clear that this is a prime example of something which falls within the purpose of the rules in paragraphs 89-91. The Appellants entered into a transaction where the risk was less than that of leasing to the shipping companies. It has then been a matter of expert evidence to identify whether that reduction fell within the "greater part" test of paragraph 90.

202. Our conclusion as to the effect of Provisions 1 and 2 for all the reasons we have set out means that the appeals must be dismissed.

Provision 3 – the Prepayments

203. Given our conclusions regarding the application of the excepted securities rules in paragraph 91 to the Fortis Bank Guarantee in the context of the Prepayments, it is incumbent on us to set out how we consider the rules in paragraphs 89-90 go on to address the extent of security provided by the Prepayments.

204. The core of the dispute regarding the Prepayments is whether they should be taken into account in de-risking the transactions for the Appellants where the Appellants have no recourse to the Prepayments or security in the form of a charge over them. Mr Sutton has worked on the basis that each £1 of prepayment has reduced the Appellants' non-compliance risk by £1, despite the lack of recourse or security and then, to put it simply, as that amount is more than 50% of the amount payable to the Appellants it follows that their non-compliance risk was reduced by more than 50%. Mr Ghosh submits that this is wrong and fundamentally the function of the Prepayments was simply to de-risk the Sub-Lease with no effect on the non-compliance risk for the Appellants. Indeed, in cross-examination Mr Sutton conceded that his £ for £ approach to calculating the effect failed to take into account any default rate on that element.

205. Mr Bremner submits that it does not matter that the Prepayments were not subject to a charge or recourse because when you look at how the arrangements were intended to work the money was ring fenced. It was placed with Fortis Finance and then deposited with Fortis

Bank so that Fortis Finance was in the position that it would be able to pay more than 50% of the sums due under the Head Lease.

206. This issue brings into focus another difference between the experts. Mr Bencard has approached his assessment by looking at the transactions overall and removing one or more Provisions. Mr Sutton started with a lease between the Appellants and the Sub-lessees and added the Provisions. Mr Bremner submitted that it should, as a matter of logic, make no difference and the assessments should meet in the middle.

207. Our view is that we must start by identifying the non-compliance risk arising from non-payment under the paragraph 89 "lease". That "lease" is the arrangements for a ship to be made available by the Appellants to the Sub-lessees, i.e. the Head lease and Sublease.

208. If all the transactions are taken into account as the starting point, then simply taking away the effect of the one Provision can be seen to have little effect where the existence of other Provisions (in particular, the Fortis Bank Guarantee) remains in place. Mr Bencard recognised that carrying out the assessments in such a way by starting with everything and removing one provision at a time could lead to the effect of different provisions being "masked". When pressed in cross-examination about his opinion that the Prepayments had no impact on the non-compliance risk because of the lack of security, it became clear that Mr Bencard was also relying upon the fact that the recipient of the Prepayments was a subsidiary of a bank which would be supported by its parent and there was in place the Fortis Bank Guarantee. The "masking" of the other Provisions was apparent which causes us to place less weight on his assessment regarding the Prepayments alone, given our conclusion to what is required by the statutory test.

209. Mr Sutton's approach of starting of adding in Provisions to a lease avoids the masking effect and on that basis is preferable. However, as Mr Ghosh submitted, Mr Sutton was wrong to start with the assumption of a lease simply between the Appellants and the Sub-lessees.

210. As said, the starting point is a Head-lease/Sub-lease structure. Although it is clear from Mr Sutton's report that in the context of the Prepayments he recognised the existence of the Head-lease/Sub-lease structure (in other words he did not assume the Prepayments were made to the Appellants), his starting point was incorrect. We are unable to identify whether that made any material difference to the conclusion.

211. More importantly though, in the context of considering the Prepayments, in cross-examination the reliability of Mr Sutton's assessment was called into question and he conceded that in the context of his methodology elsewhere it was incorrect to simply use a pound for pound approach rather than take into account a default rate. Given that as we have already identified, the non-compliance risk involves the concept of a loss as a result of non-payment we would expect a default rate to be applied in this context as well as that of the other Provisions.

212. We are therefore left with a potentially unsatisfactory conclusion that neither of the opinions is sufficiently reliable. However, in this case we are satisfied that the matter can be resolved without need to refer to an opinion regarding the amount of the non-compliance risk.

213. Stepping back from the experts' opinions, we agree with Mr Ghosh that the Intermediate Lessor in the paragraph 89 lease has received more than 50% of the funds needed to pay the rentals due under the Head-lease, but in circumstances where the Appellants have no security, pledge, commitment or other recourse to those funds. The Intermediate Lessor could, as Mr Ghosh suggested, have made an investment which failed.

There is nothing in the documents to limit the Intermediate Lessor's use of the money. As noted earlier, the Appellants' risk of loss from non-payment rests in the Head Lease.

214. Therefore the Prepayments alone would not be a provision of the transactions which under paragraph 90 causes the Appellants to cease to be entitled to capital allowances.

CONCLUSION

215. The Appellants' appeals are dismissed for the reasons we have set out.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

216. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

JUDGE TRACEY BOWLER
TRIBUNAL JUDGE

Release date: 06th NOVEMBER 2024