**[2021] UKUT 109 (TCC)**

**Appeal number: UT/2020/0028**

***Tonnage Tax – interpretation of Paragraph 85 Schedule 22 Finance Act 2000 - whether company leaving tonnage tax regime liable to balancing charge under Capital Allowances Act 2001 on sale of assets following exit – no – appeal dismissed***

**UPPER TRIBUNAL**
**(TAX AND CHANCERY CHAMBER)**

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| **THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS** | **Appellants** |
| **-and-** | |
| **UNICORN TANKSHIPS (428) LIMITED** | **Respondent** |

**TRIBUNAL** **MR JUSTICE TROWER**
**JUDGE SWAMI RAGHAVAN**

**Sitting in public by way of remote video hearing, treated as taking place in London, on 17 March 2021**

**Elizabeth Wilson QC, Charles Bradley, counsel instructed by the General Counsel and Solicitor to HM Revenue & Customs for the Appellants**

**Francis Fitzpatrick QC, counsel, instructed by BDO LLP, for the Respondent**

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DECISION

1. This is an appeal by the Commissioners for Her Majesty's Revenue and Customs ("HMRC") against the decision of the First-tier Tribunal ("FTT") published as *Unicorn Tankships (428) Limited v HMRC* [2019] UKFTT 689 (TC).

2. The appeal before the FTT raised issues of statutory interpretation on the interaction of the tonnage tax rules in Schedule 22 Finance Act 2000 ("Schedule 22") and the capital allowances legislation in Part 2 of the Capital Allowances Act 2001 ("CAA") when a company leaves the tonnage tax regime. Under the tonnage tax regime, maritime fleet companies that meet certain conditions, can elect to more favourable taxation of their profits, but while in the regime, cannot benefit from capital allowances deductions. The taxpayer company, Unicorn Tankships (428) Limited ("Unicorn"), sold a ship after leaving the tonnage tax regime. The case concerned whether a balancing charge of £12,579,499 arose under the capital allowances legislation, as HMRC argued and reflected in its closure notice amending Unicorn's corporation tax return. The FTT rejected HMRC's interpretation that the balancing charge arose and allowed Unicorn's appeal against the closure notice and amendment. With the permission of the Upper Tribunal, HMRC now appeal against that FTT decision.

## Legislative Background

*Capital Allowances regime*

3. In broad terms, the regime established by the CAA allows expenditure on capital assets to be treated as expenses in calculating the profits of the trade. (As *capital* expenditure, those expenses would not otherwise be able to be set against *revenue* profits). Under s3 CAA, the allowances are given effect, for corporation taxes, on the making of a claim. In this appeal we are concerned with provisions relating to capital allowances in respect of expenditure on plant and machinery. These are contained in Part 2 of CAA which contains each of the sections referred to in this part of our judgment.

4. Section 11(1) provides that allowances are available under Part 2 if a person carries on a qualifying activity (listed in s15(1) – and which include "a trade") and incurs qualifying expenditure.

5. In relation to qualifying expenditure, s11(4) provides:

> "The general rule is that expenditure is qualifying expenditure if- (a) it is capital expenditure on the provision of plant or machinery wholly or partly for the purposes of the qualifying activity carried on by the person incurring the expenditure, and (b) the person incurring the expenditure owns the plant or machinery as a result of incurring it."

6. The legislation provides for different types of capital allowances (annual investment allowances, first-year allowances, writing-down allowances and balancing allowances). It also provides for balancing charges. In broad terms, the expenditure allowed for under the rules reflects an assumed level of the depreciation of the assets over time. Part 2 of CAA also deals with disposals. When the asset is disposed of, and there is then an actual figure for the depreciation there is a reckoning to see if the depreciation assumptions resulted in too little expense being deducted (in which case there is a balancing allowance) or too much (in which case there is a balancing charge). As far as allowances and charges are concerned, this appeal is concerned with writing down allowances and balancing allowances and also with balancing charges.

7. Section 53 provides that qualifying expenditure has to be pooled for the purposes of determining any entitlement to a writing down allowance and a balancing allowance and any liability to a balancing charge. There are different types of pools to which the expenditure is to be allocated: "single asset pools" "class pools" and the "main pool". Different depreciation assumptions are made depending on the pool, hence the need to know the nature of the expenditure that goes into each pool. In the factual context of this appeal, it is worth noting that Chapter 12 Part 2 provides rules specific to ships. If allocated to a pool, qualifying expenditure must be allocated to a single asset pool subject to an election to allocate it to the "appropriate non-ship pool".

8. Section 55 provides for the determination of any entitlement to a writing down allowance or a balancing allowance or any liability for a balancing charge as follows:

> (1) Whether a person is entitled to a writing-down allowance or a balancing allowance, or liable to a balancing charge, for a chargeable period is determined separately for each pool of qualifying expenditure and depends on—
>
> (a) the available qualifying expenditure in that pool for that period ("AQE"), and

> (b) the total of any disposal receipts to be brought into account in that pool for that period ("TDR").
>
> (2) If AQE exceeds TDR, the person is entitled to a writing-down allowance or a balancing allowance for the period.
>
> (3) If TDR exceeds AQE, the person is liable to a balancing charge for the period.
>
> (4) The entitlement under subsection (2) is to a writing-down allowance except for the final chargeable period when it is to a balancing allowance...

9. Thus, if AQE in respect of a chargeable period (which will reflect the amount of qualifying expenditure that is left over after allowances have been taken as expenses) exceeds TDR – then there is a writing down allowance or a balancing allowance. The balancing allowance, if applicable, recognises that the assumed depreciation in allowing the expenses will not have reflected the greater depreciation which actually occurred. Conversely, if the asset was sold for more than the assumed depreciation allowed, then the taxpayer is liable to a balancing charge.

10. In respect of a chargeable period, s56(1) provides that the amount of the writing down allowance is 20% of the excess. Section 56(6) provides that the amount of the balancing charge is the amount by which the disposal receipts exceed AQE.

11. As regards how AQE is determined, the rules are set out in s57. That section provides as a general rule (subject to exceptions which are not relevant) that the AQE is the qualifying expenditure allocated to the pool in accordance with s58 plus any unrelieved qualifying expenditure (UQE) carried forward in the pool from the previous chargeable period under s59.

12. Section 58 sets out a number of requirements. Amongst these are that a person must not allocate qualifying expenditure to a pool for a chargeable period unless the person owns plant or machinery for some part of the chargeable period.

13. Under s59, UQE arises where in respect of the previous period the AQE exceeds the TDR.

14. In summary, for a chargeable period, AQE for a pool is any qualifying expenditure initially allocated to the pool in that period plus the amount of qualifying expenditure, after writing down, carried forward from the previous period.

15. Under s60 the term "disposal receipt" is defined to mean the disposal value a person is required to bring into account in accordance with s61, s62, and s63 when read with s64 and s264(3). A disposal event is defined to mean any event of a kind that requires disposal value to be brought into account.

16. Section 61(1)(a) provides that a person who has incurred qualifying expenditure is required to bring the disposal value of plant or machinery into account for the chargeable period in which the person ceases to own the plant or machinery. That is the provision relevant here to Unicorn's case, which involved the sale of a ship.

17. Section 62(1) provides however that:

> "the amount of any disposal value required to be brought into account by a person in respect of any plant or machinery is limited to the qualifying expenditure incurred by the person on its provision".

18. This provision thus caps the amount of disposal value for the purpose of calculating whether there is a balancing charge or a balancing allowance. The central issue in the appeal is whether this cap on qualifying expenditure applies. That in turn depends on what the amount of qualifying expenditure is taken to be where a person leaves the tonnage tax regime. That amount depends on the true construction of Schedule 22 paragraph 85 which we set out and discuss below.

19. The final provision of the CAA relevant to the arguments as to why Unicorn was not liable to a balancing charge, is s64. This section provides an exception, on which Unicorn relies, to the requirement to bring a disposal value into account in a pool for a chargeable period in respect of plant or machinery. The exception applies "if none of the qualifying expenditure is or has been taken into account in a claim in determining the person's available qualifying expenditure in the pool for that or any previous chargeable period…". Section 64(5) explains that a person takes expenditure into account in a claim if the person "takes it into account – a) in a tax return; b) by giving notice of an amendment of a tax return; or c) in any other claim under this Part."

*Tonnage tax*

20. Having sketched out the relevant CAA provisions which apply to a person who is not within tonnage tax we now turn to the provisions in that regime. A helpful and succinct summary of the tonnage tax regime was set out by the FTT in its decision which we gratefully adopt with some minor modifications. The tonnage tax regime is a scheme providing for favourable taxation of the UK maritime fleet and constitutes a regime of approved state aid. It was introduced by s82 Finance Act 2000, pursuant to the terms of which Schedule 22 has effect and was subject to amendment in 2005.

21. In summary, shipping companies which elect into the tonnage tax regime pay corporation tax on their tonnage tax profits in place of corporation tax on the relevant shipping profits. In essence, under the regime, corporation tax is payable applying the normal rate of corporation tax on a deemed daily profit calculated by reference to the net tonnage of vessels operated by the shipping company. Tonnage tax is payable irrespective of the profitability of the trade associated with the operation of the vessels concerned and, in the case of otherwise profitable activity, tax payable under the regime will usually be significantly lower than tax payable on the profits of the trade.

22. Tonnage tax is a ring-fenced regime which explicitly envisages that there shall be a general exclusion of reliefs and deductions. In order to enter the regime, a shipping company must operate qualifying ships (broadly seagoing ships of 100 tons or more gross tonnage used for the carriage by sea of passengers or cargo); undertake the strategic and commercial management of the vessels in the UK and enter into a training commitment to train a minimum of 1 in 15 UK/EEA officers (subject to a minimum of 1). Certain EU/EEA ‘flagging’ (registration) rules must also be met. These requirements were set in order to ensure compliance with the EU Commission’s state aid approval of the regime. A tonnage tax election is made in respect of a group and the election has effect in respect of all qualifying companies. The tonnage tax election lasts for 10 years and cannot be revoked. As the regime is a favourable one it is specifically subject to anti avoidance provisions contained in Schedule 22 paragraphs 41 and 42. Paragraph 41 makes it a condition of remaining within the regime that a company is not party to any transaction or arrangement that is an abuse of the regime. Paragraphs 42, 138 and 139 result in the exclusion of any company which is involved in a prohibited transaction or arrangement from the regime and the imposition of exit charges.

23. For the purposes of this appeal, the critical parts of Schedule 22 are the provisions in Part IX which deal with the treatment of those entering, in, and leaving tonnage tax

as regards capital allowances (paragraph 68), the specific provisions regarding leavers (paragraph 85), and the interpretation provision (paragraph 88).

24. Paragraph 68 provides:

> (1) This Part of this Schedule makes provision about capital allowances where a company enters, leaves or is subject to tonnage tax.
>
> (2) The general scheme of this Part of this Schedule is that—
>
> (a) entry of a company into tonnage tax does not of itself give rise to any balancing charges or balancing allowances,
>
> (b) a company subject to tonnage tax is not entitled to capital allowances in respect of expenditure incurred for the purposes of its tonnage tax trade, whether before or after its entry into tonnage tax, and
>
> (c) on leaving tonnage tax—
>
> (i) a company is treated as having incurred qualifying expenditure on its tonnage tax plant and machinery assets of an amount equal to the lower of cost and market value, where it leaves tonnage tax on expiry of an election or on the taking effect of a withdrawal notice, but
>
> (ii) otherwise, a company is put broadly in the position it would have been in if it had never been subject to tonnage tax.
>
> (3) A company's tonnage tax trade is not a qualifying activity for the purposes of determining the company's entitlement to capital allowances.

25. Paragraph 85, headed "Exit: plant and machinery", then makes specific provision for what happens when companies leave tonnage tax.

> 85 (1) If a company leaves tonnage tax—
>
> (a) the amount of qualifying expenditure under Part 2 of the Capital Allowances Act 2001 (plant and machinery allowances) (plant and machinery), and
>
> (b) the pools to which such expenditure is to be allocated for the purposes of that Part,
>
> shall be determined under this paragraph.

(1A) Sub-paragraph (1C) applies where the company leaves tonnage tax—

(a) on the expiry of a tonnage tax election, or

(b) on a tonnage tax election ceasing to be in force under paragraph 13(2A)(taking effect of withdrawal notice under paragraph 15A).

(1B) In any other case, sub-paragraph (2) applies.

(1C) Where this sub-paragraph applies, the amount of qualifying expenditure in respect of each asset used by the company for the purposes of its tonnage tax activities and held by the company when it leaves tonnage tax shall be taken to be—

(a) the market value of the asset at the time the company leaves tonnage tax, or

(b) if less, the amount of expenditure incurred on the provision of the asset that would have been qualifying expenditure if the company had not been subject to tonnage tax.

(2) Where this sub-paragraph applies, for each asset used by the company for the purposes of its tonnage tax activities and held by the company when it leaves tonnage tax there shall be determined—

(a) the amount of expenditure incurred on the provision of the asset that would have been qualifying expenditure if the company had not been subject to tonnage tax, and

(b) the written down value of that amount by reference to the period since the expenditure was incurred.

(3) The Inland Revenue shall make provision by regulations as to the basis on which the writing down is to be done. The regulations may make different provision for different descriptions of asset.

26. The regulations made pursuant to Schedule 22 paragraph 85(3) are the Tonnage Tax Regulations 2000/2303 ("TTR"). Regulation 4(2) provides that the 'written down value of the paragraph 85(2)(a) amount for the asset shall be determined by multiplying that amount by the percentage given by the table in paragraph 3'. The percentage is arrived at as follows under the table. Column 1 of the table is headed 'Length of qualifying holding period for the asset'. The qualifying holding period ('QHP') is the period from the acquisition of the asset until the date on which the company leaves tonnage tax. In the present case, the QHP is '5 years and one day to 6 years' as the

relevant ship was acquired on 22 June 2004 and Unicorn left tonnage tax on 21 June 2010. The appropriate percentage listed on those facts is 15%.

27. Paragraph 88 provides for interpretation of Part IX:

> 88 (1) In this Part of this Schedule—
>
> “capital allowance” means any allowance under the Capital Allowances Act 2001;
>
> “qualifying activity” means any activity in respect of which a person may be entitled to a capital allowance;
>
> “qualifying expenditure” means expenditure in respect of which a person is or may be entitled to a capital allowance.
>
> (2) In this Part of this Schedule any reference to pooling or to single asset pools, class pools or the main pool shall be construed in accordance with sections 53 and 54 of the Capital Allowances Act 2001.
>
> (4) Other expressions relating to capital allowances have the same meaning in this Part of this Schedule as in the Capital Allowances Act 2001.

## Facts and FTT decision in brief

*Facts*

28. The FTT’s Decision proceeded on the basis of agreed facts which it set out at [2] of its decision. For present purposes it is sufficient to note the following.

29. Unicorn’s group made a group tonnage tax election on 19 September 2001 with effect from 1 January 2001 (pursuant to Schedule 22 paragraph 7(1)(b)). Unicorn became subject to tonnage tax on its acquisition of a ship, the Nyathi (“the Ship”), on 22 June 2004, for US$25,320,135 (pursuant to Schedule 22 paragraph 16).

30. On 21 June 2010, Unicorn ceased to be subject to tonnage tax. That was because it ceased to be a qualifying company (as a result of the extension of a bareboat charter of the Ship beyond a term of three years (pursuant to Schedule 22 paragraphs 13(2)(b) and 18(1), (3) and (5)).

31. On 13 December 2010 Unicorn entered into an agreement, which took effect on 31 December 2010 to sell the Ship for US$23,250,000.

*FTT Decision*

32. As we explain below, the issues before us turn on the correct statutory interpretation of the exit provisions in Schedule 22. The parties' arguments before the FTT covered much of the same ground that was covered before us so we will not rehearse those in detail now but will deal with them when we engage with the interpretation issues at the centre of the appeal.

33. Unicorn's appeal before the FTT basically raised two issues. Both were matters of statutory interpretation which were relevant to whether a balancing charge of £12,579,499 (giving rise to corporation tax of some £3.5 million) arose. The first concerned the interpretation of s64 CAA. Unicorn argued, contrary to HMRC's interpretation, that s64 meant there was no statutory basis for bringing the disposal value of the ship into the balancing charge calculation so that no balancing charge could then arise. That section (see [19] above) provides that a person is not required to bring a disposal value into account in a pool for a chargeable period if none of the qualifying expenditure had been "taken into account in a claim in determining the person's available qualifying expenditure…". No such claim for capital allowances (which claim needed to be made on Unicorn's tax return) was made by Unicorn. If Unicorn succeeded on this issue, no balancing charge arose and that disposed of the appeal.

34. The second issue, if Unicorn was unsuccessful on the s64 issue, concerned the interpretation of Schedule 22 paragraphs 68 and 85. The FTT explained (at [210]) that it did not feel able to determine the s64 issue first, as to deal with it in isolation would take it out of the context of the way the tonnage tax and the capital allowance provisions operated "at their intersections". It accordingly dealt with the second issue (interpretation of paragraph 68 and paragraph 85) first.

35. The central issue when determining the circumstances in which the disputed balancing charge had arisen was the figure to be regarded as "qualifying expenditure" for the purposes of the cap on "disposal value" in s62(1) CAA, once the exit provisions of Schedule 22 paragraph 85 were taken into account. Under the CAA, a balancing charge arises where there is an excess of the disposal value, capped at "qualifying expenditure", over the available qualifying expenditure ("AQE"). (This is expressed in

s56(6) as TDR exceeding AQE). There was no dispute that the AQE is $3.7 million, representing the written down value of the Ship in accordance with the TTR. The dispute concerned the total disposal amount ($23 million), once it was capped by "qualifying expenditure".

36. HMRC argued that the cap does not operate. On their construction of Schedule 22 paragraph 85, the "qualifying expenditure" for the purposes of s62(1) CAA amounts to c.$25 million, which was greater than the total disposal amount of $23 million.

37. Unicorn's argument, with which the FTT agreed in upholding its appeal, is that the cap of "qualifying expenditure", once Schedule 22 paragraph 85 is worked through according to Unicorn's interpretation, is $3.7 million. The TDR, so capped at $3.7 million, did not exceed the AQE of $ 3.7 million. No balancing charge therefore arose.

38. There was no dispute that: 1) outside the realm of tonnage tax the normal position was that capital allowances, and therefore the possibility of a balancing charge or allowance, could only be obtained if a company made a claim in respect of capital allowances 2) when in tonnage tax, a company could not claim capital allowances. The disputed issue concerned whether, when a company in the tonnage tax regime, leaves the regime, a balancing charge could arise despite no claim for capital allowances having been made.

39. The FTT understood the crux of HMRC's case to be that the effect of paragraphs 68 and 85 was that assets to which the capital allowances regime would apply, were treated "as if a capital allowance claim were de facto given as part of the [tonnage tax regime]" (FTT decision at [96]). It considered it "critical to understand the full extent of the relationship between the capital allowances regime and the tonnage tax regime at every point at which they intersect with one another" (FTT decision at [97]). The FTT accordingly (at [99] – [156]) proceeded to work through an impressive array of hypothetical permutations based on examples "loosely based on [Unicorn's] facts". These covered for instance a situation where a company, not electing into the tonnage tax regime, made a claim for allowances, where allowances were deferred, not claimed, or postponed. As neither party invited us to proceed similarly we need not dwell in detail on these save to note that at [203], after addressing the interpretation of paragraph 85, the FTT made an additional point that:

> "…there is nothing in the provisions of the TTR which can be interpreted as deeming or even inferring that it is an inherent feature of the TTR that

> it substitutes a figure for capital allowances which must then be recouped through a balancing charge. As articulated …above the Tribunal considers in fact the opposite is the case. The TTR is a discrete and ring fenced regime that simply removes the company from the capital allowances regime for the period that a tonnage tax election is effective."

40. The core of the FTT's reasoning as to why it preferred Unicorn's statutory interpretation to HMRC's was at [197] to [202] of its decision:

> "197. The approach to interpretation of the legislative provisions is to give them the meaning ascribed by Parliament by reference to the defined terms or the natural meaning of the words used and by reference to their statutory context.
>
> 198. Expenditure and QE are different terms for the purposes of Sch 22. Paragraph 88 defines QE as "expenditure in respect of which a person is or may be entitled to capital allowances [allowances under CAA]". Paragraph 85 requires that the amount of QE on exit from the TTR shall be determined by its terms. Reg 4 TT Regs is consistent in its reference to a percentage application to a figure of expenditure resulting in a figure of QE. For companies leaving in the circumstances falling within paragraph 85(2), the determination of QE requires that expenditure be identified and written down but the product of that exercise on the language chosen by Parliament is unquestionably an amount of QE.
>
> 199. Section 57 defines AQE by reference to QE and UQE with s55 CAA using AQE as the reference point for determining whether a balancing charge is due. In an unfortunately circular way, s59 CAA then uses AQE to define UQE. Entirely consistent with the scheme of capital allowances, s62(1) limits the amount of disposal value required to be brought into account when calculating TDR by reference to QE and not AQE or UQE.
>
> 200. Whilst it may be notable that within Part IX, Sch 22 does not reference AQE, UQE and QE are used, unsurprisingly, in a way entirely consistent with the provisions of the CAA. The Tribunal considers that to interpret the provisions of paragraph 85(2) as defining either the UQE or AQE of each asset on exit from the TTR would be inconsistent with the language chosen by Parliament.
>
> 201. The Tribunal therefore considers that the product of the paragraph 85(2) calculation limits the availability of WDAs to a sum

> commensurate with a deemed (though possibly, by reference to the statutory rate of WDA, overstated) depreciated value of the assets. However, in choosing to determine the amount of QE and not AQE/UQE, Parliament must be taken to have chosen to do so taking account of the consequences of that decision.
>
> 202. The Tribunal acknowledges that, in doing so, capital allowances given prior to entry into the TTR may not be recouped but considers that an inevitable consequence of the statutory language used. But it does not justify the conclusion advanced by HMRC."

41. The FTT upheld Unicorn's appeal on that basis. It dealt briefly with the s64 issue (at [210] to [213]), again agreeing with Unicorn. It remains the case that if Unicorn is right on its case on 64 CAA, then the arguments in relation to Schedule 22 paragraphs 68 and 85 do not arise. Before us, however neither party took issue with the order in which the FTT dealt with the issues. They dealt with the paragraph 68 and 85 issues first. We shall too.

*Summary of parties' cases*

42. HMRC's grounds raised what they submitted were a number of errors of law. Ultimately these all turn on an issue of statutory interpretation of the provisions governing a company's capital allowance treatment when it leaves the ring-fenced regime of tonnage tax, and then disposes of a relevant asset. Does a balancing charge arise under the capital allowances legislation, as HMRC maintained? Or is it the case that no such charge arises as Unicorn submitted, and as the FTT found?

43. As explained above (see [35] to [37]) that issue turns on what figure is regarded as "qualifying expenditure" for the purposes for the cap on "disposal value" in s62(1) CAA, once the exit provisions of Schedule 22 paragraph 85 are applied.

44. Mr Fitzpatrick, for Unicorn, submitted that the interpretation of the provision is plain. Paragraph 85(1)(a) directs the determination of the amount of qualifying expenditure. This, he emphasised is "under Part 2 of [CAA] (plant and machinery allowances) (plant and machinery)". Paragraph 85(2) then provides that qualifying expenditure is worked out by a two-step process:

(1) determine the acquisition cost of the asset. That is the expenditure that would have been qualifying expenditure had the company not been subject to tonnage tax, namely the acquisition cost,

(2) determine the written down value of that amount by reference to the period since the expenditure was incurred. The result is a single figure of qualifying expenditure.

45. He also said that the TTR, which came into force contemporaneously, with Schedule 22 supports Unicorn's case that paragraph 85 determines a single figure, being the amount of qualifying expenditure for the purposes of CAA, because column 2 of the table referred to in regulation 4(2) TTR (see [26] above) is headed 'Percentage of the paragraph 85(2)(a) amount <u>which is qualifying expenditure under Part II of the 1990 Act</u>' (emphasis added). The appropriate percentage listed is 15%.

46. Ms Wilson, for HMRC, argued that this interpretation is wrong for a number of reasons:

(1) Schedule 22 paragraph 85(2) requires two separate amounts to be determined each of which have a natural counterpart in CAA. Amount a) represents "qualifying expenditure" and amount b) represents written down AQE (which becomes the carried forward AQE of the relevant period) for CAA purposes.

(2) Crucial to understanding paragraph 85(1) is the fact that it requires pooling. Pooling is the way in which effect is given to the CAA provisions requiring expenditure to be aggregated for the purposes of determining a person's entitlement to capital allowances and their amount. It is inherent in the concept of pooling that the pool must have an amount of AQE. There is no need to specify a separate figure for AQE. There is, she submits, no need for paragraph 85 to state expressly that AQE arises. That happens automatically on an amount of qualifying expenditure being pooled. In the case of paragraph 85(1C) leavers, the qualifying expenditure and AQE are the same. This argument ties back to a broader point Ms Wilson made that paragraph 85 is written in the knowledge that, once pooling occurs, it carries with it certain automatic incidents.

(3) Unicorn's interpretation also fails to recognise that "qualifying expenditure", under paragraph 88(1) has its own definition in Schedule 22

that is not identified with the CAA meaning of the term. The Schedule 22 definition (in paragraph 88(1) is "expenditure in respect of which a person is or may be entitled to a capital allowance" where "capital allowance" is defined to mean "any allowance under the Capital Allowances Act 2001". The drafter could simply have cross referred to qualifying expenditure in s11 CAA if that was the intended meaning but did not do so.

(4) The heading to the table in Regulation 4 TTR could not determine the meaning of paragraph 85. The sole purpose of the table was not to determine the character of the amount but to give "the percentage" to apply to the paragraph 85(2)(a) amount in order to arrive at the paragraph 85(2)(b) amount.

47. There was also a disputed issue between the parties as to whether paragraph 85 *required* the allocation of assets to a pool, as HMRC argued or whether, as Unicorn submitted, by reference to contrasting language used elsewhere in the legislation, where something was required, that pooling depended on whether a capital allowances claim was made. Pooling was therefore a matter of choice. However, Unicorn argued that, even if, contrary to its position, the pooling was mandatory, the figure produced by paragraph 85 is a single figure of qualifying expenditure for CAA purposes.

48. Both parties' submissions also covered the compatibility of their interpretation with their understanding of the policy underlying the legislation and how that fitted in with the consequences that arose depending on which interpretation was adopted.

49. Unicorn emphasised that the rationale for balancing charges was to recoup excess allowances that had actually been claimed (there being no obligation to claim allowances). There was nothing surprising in the provisions resulting in Unicorn not being liable to a balancing charge in circumstances where Unicorn had not at any point claimed allowances.

50. HMRC acknowledged that the capital allowances regime entails a number of options (for instance which pool to put the asset in - see [7] above). But, they said that the difficulty in working out how such options *might have been* exercised is precisely why the legislation has taken the stance of assuming that the company went down a particular route: the company is required to pool and as soon as that was required balancing charges, or if applicable on the facts, allowances, become relevant. HMRC also highlighted the different treatment of those leaving because the election period has

expired or pursuant to a withdrawal notice (the leavers under paragraph 85(1C)). Those leavers were intended to be treated in a more beneficial way than those leaving otherwise (such as Unicorn which was covered by paragraph 85(2)).

**Discussion**

51. The issue at the heart of this appeal is which of the parties' competing interpretations of Schedule 22 paragraph 85 is correct. Before engaging with that, it is useful to put the provision in its wider context.

52. Paragraph 85 sits within Part IX of Schedule 22, which sets out the "ring fence" in respect of capital allowances. As the introductory paragraph (paragraph 68) to the Part explains, Part IX makes provision about capital allowances where a company enters, leaves or is subject to tonnage tax. The general scheme is that a company subject to tonnage tax is not entitled to capital allowances for expenditure incurred for the purposes of its tonnage tax trade. Paragraph 68 distinguishes on the one hand between companies which leave on expiry of the tonnage tax election (a 10-year period which is extendable), or on the taking effect of a withdrawal notice, and on the other hand companies which leave otherwise. Unicorn is a company which has left otherwise. For leaving companies such as Unicorn, the general scheme of Part IX is that the company "is put broadly in the position it would have been in if it had never been subject to tonnage tax".

53. As set out in Regulation 4(2) of TTR the 'written down value of the paragraph 85(2)(a) amount for the asset shall be determined by multiplying that amount by the percentage given by the table in paragraph 3'. On the facts of this case, the appropriate percentage applied to the expenditure incurred on the asset ($25,320,135) is 15% giving a figure of $3,798,020.25.

54. Whether a balancing charge arises in Unicorn's case, depends on whether the cap on the disposal amount in s62 CAA applies. The cap is set by reference to qualifying expenditure. There did not appear to us to be any argument that, from the perspective of s62, were it not for specific Schedule 22 provisions, a company exiting tonnage tax would not have any qualifying expenditure for CAA purposes. That would appear to follow from paragraph 68(2)(b) (company subject to tonnage tax not entitled to capital allowances in respect of expenditure incurred for the purposes of its tonnage tax trade).

If there is a figure to be plugged in as the figure for qualifying expenditure, it can only be one which arises from the operation of paragraph 85.

55. We turn then to the interpretation of that provision. One of the issues between the parties was whether it was correct that the provision requires mandatory pooling. While there was much debate on this issue, it is not one which in our view needs to be determined unless we disagree with Unicorn's primary case on interpretation given Unicorn argued that their interpretation is correct irrespective of whether pooling is mandatory. (The FTT agreed with HMRC (at [163]) that pooling was mandatory. That conclusion was obiter to its decision that paragraph 85 determined a single figure of qualifying expenditure and that Unicorn's appeal should therefore be allowed).

56. We will therefore first consider the interpretation of paragraph 85 on the assumption that HMRC are correct, and the company is required to allocate assets to a pool.

57. As an opening observation we note that the two subparagraphs of paragraph 85 do not mesh neatly together. In particular, paragraph 85(1) states that the ensuing paragraphs will determine first, the amount of qualifying expenditure under Part 2 CAA, and second, the pools to which such expenditure is to be allocated for the purposes of that Part. The delivery, however, of this expectation is somewhat opaque. Paragraph 85(2) does not explicitly follow on to state such an amount (at least for leavers others than those provided for in 85(1C).). This apparent mismatch between the expectation paragraph 85(1) sets, and what 85(2) delivers cannot be attributed to the addition of new sections and amendments in 2005. It was present in the provision as originally enacted.

58. Because of this, both parties' constructions require a degree of expansive interpretation. Thus, Mr Fitzpatrick's "single figure" interpretation requires the wording of paragraph 85(2) to be stretched, so that subparagraphs 85(2)(a) and 85(2)(b) read as making provision for two sequential steps pursuant to which sub paragraph 85(2)(b) represents the outcome of qualifying expenditure for CAA purposes. Ms Wilson's interpretation requires some expansion of the term "qualifying expenditure" in paragraph 85(1) so as to encompass not just qualifying expenditure but also available qualifying expenditure thus making sense of the reference in paragraph 85(2) to two different figures.

59. Nor for that matter does paragraph 85(2) explicitly state, in clear terms, the pools to which expenditure is be allocated. The parties submitted that the provision did tackle the subject: Ms Wilson suggested that the reference to "each asset" meant that it did so by providing that pool allocation was to be done on an asset-by-asset basis. Mr Fitzpatrick pointed to the interpretation provision (paragraph 88(2)) which provides that references in that part of Schedule 22 "to pooling or to single asset pools, class pools or the main pool" are to be "construed in accordance with sections 53 and 54" of CAA. We need say no more on the point as it is not a matter we need to reach a conclusion on for the purposes of this case.

60. HMRC were right to draw attention to the interpretation provisions contained in paragraph 88(1) (see paragraph [46(3)] above): any analysis of paragraph 85 must take account of the definition of "qualifying expenditure" in that section. If one substitutes the words of the definition (incorporating the "capital allowance" definition) into the text of paragraph 85, paragraph 85(1) will read:

> "the amount of [expenditure in respect of which a person is or may be entitled to any allowance under the Capital Allowances Act 2001] under Part 2 of the Capital Allowances Act 2001 (plant and machinery allowances) (plant and machinery)"

61. On the face of it, that is helpful to HMRC's case because it would appear to envisage that the determination made by the paragraph is not tied to just "qualifying expenditure" as that term is defined in s11 CAA (at [5] above). However, any assistance derived is undermined by the fact the definition would also need to be inserted into Schedule 22 paragraph 85(2)(a). That would then read:

> "the amount of expenditure incurred on the provision of the asset that would have been [expenditure in respect of which a person is or may be entitled to any allowance under the Capital Allowances Act 2001] if the company had not been subject to tonnage tax, and…".

62. That would not result in the paragraph 85(2)(a) amount being "qualifying expenditure" for the purposes of the cap in s62(1) as there is no provision which prescribes that the paragraph 85(2)(a) amount is to be regarded as qualifying expenditure for that purpose.

63. It might be asked why a separate definition of "qualifying expenditure" is required for Schedule 22 purposes when no capital allowances apply to a company's tonnage

tax trade when in the regime. However, it is that very fact which gives rise to the need for a separate definition in order to cover the situation in which a company leaves tonnage tax and is then enabled to claim capital allowances for the purposes of its tonnage tax trade. It is also relevant, that the drafter has used the term "qualifying expenditure" and not used some other more generic term. This reflects the fact that the starting point to any analysis of any CAA claim will be to identify the amount of qualifying expenditure that has been incurred. However, the drafter could not simply cross refer to qualifying expenditure in s11 CAA, as HMRC suggest might have been done, because companies in tonnage tax do not have qualifying expenditure; that needs to be deemed. In order for something to be deemed as qualifying expenditure for CAA purposes, the drafter needed to have an autonomous definition of the thing which is sought to be captured by the deeming. In our view that is one of the functions of the definition.

64. Understood in those terms, the fact there is a separate Schedule 22 definition of qualifying expenditure is something which is consistent with Unicorn's depiction of paragraph 85(2) generating a single figure once both the steps a) and b) are worked through. The recourse, in paragraph 85(2)(a) to the Schedule 22 definition of qualifying expenditure, as opposed to qualifying expenditure under s11 CAA reflects that subparagraph's nature as an intermediate step to deriving the sum which will function as "qualifying expenditure" for CAA purposes only once subparagraph b) is worked through too, and not the end result. Subparagraph a) is simply a means to an end to deeming a qualifying expenditure figure which can then be plugged into the Capital Allowances legislation. (While the Schedule 22 definition of qualifying expenditure, as discussed above, is also deployed at the outset in paragraph 85(1), it has a different overall interpretation in that context because there, it is followed by the words "Under Part 2 of [CAA]…".)

65. It is also notable that s 55 CAA defines "available qualifying expenditure" ("AQE") as a separate concept within a pool of "qualifying expenditure" but that the drafter has not chosen to make use of that either in paragraph 85(1) or in paragraph 85(2)(b). That is a point which suggests that paragraph 85 is not seeking, contrary to what HMRC argue, to stipulate an amount of AQE for CAA purposes.

66. The fact that the provision made by paragraph 85(1C) in respect of those who leave upon expiry of a tonnage tax election or pursuant to a withdrawal notice taking effect also points towards a single figure, which functions as qualifying expenditure under

Part 2 and lends support to Unicorn's interpretation that paragraph 85(2) arrives at the same figure of qualifying expenditure for CAA purposes. As Mr Fitzpatrick argued, there is no reason to suppose that the outcome contemplated by paragraph 85(2) should be any different to the single figure outcome produced by the application of paragraph 85(1C).

67. As to Ms Wilson's submission that, for the purposes of Schedule 22 paragraph 85(1C), qualifying expenditure and AQE were the same and that paragraph 85 was written in the knowledge that certain incidents followed automatically once there is pooling, we note that this acknowledges that, at a minimum, there is a need to state the qualifying expenditure to be allocated to the pool. That cannot follow automatically as in CAA terms there was never any qualifying expenditure which arose when the company was in the ring-fenced tonnage tax regime. But, if that is all that is required, with the rest of the consequences following automatically, there should then be no need to give the phrase "qualifying expenditure" in paragraph 85(1) a broad meaning which encompasses qualifying expenditure and AQE as the context requires. It ought to have been sufficient to say that the provision would simply determine the amount of qualifying expenditure (and the pools to which the qualifying expenditure was applied). The argument regarding automatic incidents following therefore suggests that the broad meaning of paragraph 85(1) is wrong, and that paragraph 85(1) is simply concerned with qualifying expenditure. But if paragraph 85(1) does not have that broad meaning, it then means that paragraph 85(2), on HMRC's interpretation, has unexpectedly, despite the ordinary language interpretation of what the provision says it sets out to do in paragraph 85(1), gone on to deal with matters beyond determining an amount of qualifying expenditure.

68. Although neither party's interpretation fits neatly with the wording of the provision, taking account of the above points, we consider that Mr Fitzpatrick's interpretation is the more straightforward and coherent one, purely as a matter of language. Schedule 22 paragraph 85(1) provides that the paragraph will determine qualifying expenditure under the relevant Part of the CAA. That is then what paragraph 85(1C) and paragraph 85(2) does.

69. While Unicorn relied on the heading of Regulation 4 (see [45] above) we do not draw much assistance from it. That provision referred to qualifying expenditure under the Capital Allowances Act 1990. Mr Fitzpatrick took us to a provision that any reference in any repealed enactment is to the rewritten provision (Schedule 3(1)

paragraph 5 CAA). However, Ms Wilson rightly pointed out the definition of "qualifying expenditure" in the 1990 Act was different to that contained in CAA.

70. Also, although we agree that the state aid background to Schedule 22 provides the context for the tonnage tax regime, we do not consider this to be of any real assistance on the issue of interpretation we have to consider. HMRC maintained that Parliament's intention in enacting Schedule 22 must have been to enact a scheme which was consistent with the continuing approval by the Commission of tonnage tax as a state aid, and they referred us to what we understand to be the only other reported case on tonnage tax: *Western Ferries (Clyde) Ltd v HMRC* [2011] UKFTT 243, [2011] SFTD 619 at [163]). This founded a submission that the relevant provisions should not be interpreted in such a way that a company subject to tonnage tax receives any benefit over and above being charged to corporation tax on a notional profit calculated by reference to tonnage. However, the premise underlying this point is that companies such as Unicorn would be receiving an additional benefit if Unicorn's construction were to be correct. As Mr Fitzpatrick points out, Unicorn are in no better position than a company, which outside of tonnage tax, claimed no capital allowances and which was therefore not liable to a balancing charge on disposal.

71. We go on to consider whether any of HMRC's wider arguments indicate that we need to revisit the interpretation advanced by Unicorn in view of any underlying policy that may be discerned or the consequences that might ensue.

*Arguments based on policy / consequences of a particular interpretation*

72. HMRC emphasised that Schedule 22 paragraphs 68 and 85 expressly distinguish, and grant a more favourable treatment to, companies that leave tonnage tax on the expiry of an election and a company, such as Unicorn that leaves otherwise and who is to be put "broadly in the position it would have been in if it had never been subject to tonnage tax". There is good sense behind that distinction. The tonnage tax regime gives rise to benefits. The price for those is meeting conditions (training UK/EEA officers, undertaking strategic and commercial management of vessels in the UK) on a long-term basis. Unicorn disposed of the ship for an amount greater than the written-down value. Its liability for a balancing charge was a consequence of it being put "broadly in the same position as if it had never been subject to tonnage tax".

73. We consider Ms Wilson was right not to press the significance of this point. As Mr Fitzpatrick explained, the distinction drawn in the legislation was still given effect by his interpretation. A "paragraph 85(1C)" leaver started its new life with the market value, or if less the acquisition cost, of the asset. It was likely to have a far higher amount of qualifying expenditure on which it could claim allowances on leaving tonnage tax as compared with a company which left otherwise. Thus, Unicorn's starting qualifying expenditure, if had left on the expiry of the election, six months later from the time it did, would have been its market value, in the region of $23 million (the ship sold for around that price 6 months earlier). Instead, as a "paragraph 85(2)" leaver, it entered the capital allowances regime with a qualifying expenditure of $3.7 million. There is no difficulty reconciling this outcome with the objective set out in paragraph 68 of the company being put "broadly in the position it would have been in if it had never been subject to tonnage tax". If Unicorn had been outside of tonnage tax and claimed capital allowances on the ship it is common ground that the figure produced, once the regulations under paragraph 85(3) are applied, is roughly equivalent to what the written-down value of the ship would have been.

74. In terms of justifying policy outcomes to the different interpretations HMRC's stance, in essence, is that there is nothing odd in Unicorn being liable to a balancing charge upon a subsequent disposal; it is simply the consequence of an assumption the company would, if it had been outside of the tonnage tax regime, have claimed allowances. Conversely Unicorn says there is nothing odd about no balancing charge arising: the company did not have the benefit of writing down allowances so there is nothing that needs to be balanced upon a disposal. Mr Fitzpatrick rightly accepted that the legislation could stipulate that a charge arose in such circumstances but argues that would be very surprising outcome and out of step with the rationale of balancing charges recouping allowances that had actually been claimed to the extent the assumed depreciation had been proved by real disposal value to be overly generous.

75. We note paragraph 85 is a generic provision which deals with leavers from the tonnage tax regime, but which gives no indication as to how the consequences of subsequent disposals might be treated. We consider we should be cautious in ascribing any particular intention as regards what is to happen upon a disposal where that is not apparent from the words of the provision. It appears to us that the relevance of the above points is more a means of checking that an interpretation does not lead to outcomes so absurd they can never have been presumed to have been intended. Neither of the outcomes which flow from the competing interpretations are of that character.

76. In our view, the outcome of Mr Fitzpatrick's interpretation, which emphasises the symmetry between a balancing charge and the actual claiming of a capital allowance is an attractive one. Ms Wilson's construction, which leads to a balancing charge or allowance arising out of what amounts to the deemed claiming of a capital allowance, is less so.

77. We mentioned previously that the FTT worked through an impressive number of hypothetical scenarios to explore the way in which Schedule 22 and CAA interacted with each other but neither party invited us to proceed similarly. While we can see why the FTT, in dealing with the arguments as understood by it, considered it necessary to go through the scenarios it did, we consider it desirable to focus on the circumstances with which this case is concerned when interpreting these provisions. Nevertheless, there is one hypothetical scenario that HMRC wished to pray in aid. HMRC highlighted that if a company had pre-entry capital allowances, these would not be recouped by balancing charges post-exit unless HMRC's construction was correct. Unicorn did not appear to dispute the premise of that concern but maintained that paragraph 77 provided the answer to that. But it is not at all clear that it does. That paragraph (headed "During: plant and machinery: disposals") is specifically stated to apply "…if when a company is subject to tonnage tax". It would not therefore appear to be relevant to a sale taking place after exit. In view of the approach we have taken, we did not invite fuller submissions on this scenario and we express no view on whether it is correct. To the extent that HMRC are correct, this consequence is not such that would mandate the rejection of Unicorn's interpretation of the provision requiring HMRC's to be adopted. Unicorn's interpretation reflects, in a way HMRC's does not, the language and structure of the provision.

*Extra-statutory materials*

78. Both parties referred us to extra-statutory materials in support of their argument. HMRC referred us to a Post Implementation Review of Tonnage Tax. This was a report prepared by the then Inland Revenue and the Department of Transport in December 2004. It included sections explaining the impetus for the changes later made in 2005 in relation to the different treatment for companies leaving before expiry of the election period. It mentioned that such companies should have no "immediate liability to deferred taxation". This, Ms Wilson explained, referred to the balance sheet liability which arose immediately, even if did not crystallise until a disposal event, when a

company left tonnage tax. The concern expressed was consistent with HMRC's interpretation of the effect of Schedule 22 paragraph 85.

79. We consider this material does not assist. It simply shows the views of the Inland Revenue and Department of Transport, on the effect of the legislation. It is of little weight in helping us to ascertain the intention Parliament had when it used the words it did in paragraphs 68 and paragraph 85 as originally enacted.

80. Mr Fitzpatrick referred us to the Explanatory Notes for Schedule 22.:

> 'When a company leaves tonnage tax, it will once again wish to claim capital allowances on expenditure incurred on machinery and plant used for the purposes of its trade. Paragraph 85(1) says that the rules in paragraph 85 should be used to determine what proportion of the company's expenditure on assets held at the time of leaving the regime will qualify for future capital allowances and which capital allowance pools that expenditure should be placed in.
>
> Those rules are set out in paragraph 85(2) which looks at the company's machinery and plant held on exit from the regime on an asset by asset basis. The amount of qualifying expenditure is calculated by taking the amount of expenditure which would have qualified for capital allowances at the time the company acquired the asset and writing down that expenditure over the period between that time and the company's exit from tonnage tax.
>
> As provided for in paragraph 85(3), the Inland Revenue will issue Regulations setting out the basis upon which expenditure should be written down up to the date of the company's exit from tonnage tax. Those Regulations will be published in draft as soon as they are available. The Regulations will include separate tables of rates to be used 1. for normal machinery and plant (including ships) and for long-life assets. The rates set will be broadly equivalent to the level of write-down that would result from a company outside tonnage tax claiming all normal allowances on the same expenditure over the same period of time.' (Unicorn's emphasis)

81. Authority suggests such notes may serve as an admissible aid to construction in so far as they "cast light on the objective setting or contextual scene of the statute, and the mischief at which it is aimed" (*Westminster v National Asylum Support Service* [2002] 1 WLR 2956 (at [2] to [6]). Although Mr Fitzpatrick, in his skeleton argument,

emphasised the underlined text, he only went as far in oral submissions as saying these were not inconsistent with his submission on interpretation. We agree.

**Conclusion**

82. It follows from what we have said that there is nothing in any of the additional points to deter us from our initial view that the interpretation advanced by Unicorn, which better reflects the language and structure of paragraph 85, is the correct one.

83. In essence, that was the conclusion the FTT reached in upholding Unicorn's appeal. The criticisms HMRC make of the FTT Decision which amount to errors of law turn, as we have indicated at the outset, on the above question of statutory construction of paragraph 85. We have determined this in Unicorn's favour. Although we have expressed our reasoning in different terms, reflecting the particular way this case has been argued before us, there was no error of law in the FTT's decision to uphold Unicorn's appeal. That is sufficient for us to dismiss HMRC's appeal.

84. In the light of that conclusion, it is not necessary to deal with the parties' submissions relating to s64.

**Disposition**

85. HMRC's appeal is dismissed.

**Signed on original**

**MR JUSTICE TROWER**

**JUDGE SWAMI RAGHAVAN**

**RELEASE DATE: 07 May 2021**