[2020] UKFTT 0295 (TC)

TC07779

INCOME TAX – deductibility of interest incurred on loans made to two interest in possession settlements in the Isle of Man in circumstances where the proceeds of the loans were ultimately used in the course of a trade carried on by a partnership between the two settlements – consideration of the facts involved in the transaction and whether or not, in the light of those facts, the interest was deductible in computing the quantum of the trading profits of the partnership which were subject to income tax in the hands of the settlors of the settlements – conclusion that the interest was not so deductible – however, as agreed between the parties, an adjustment to the quantum of the trading profits of the partnership for work in progress would be allowed – subject to that adjustment, appeals dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal number: TC/2012/08177-78; TC/2013/01826-27

BETWEEN

IAN SHINER and DAVID SHEINMAN **Appellants**

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: JUDGE TONY BEARE

The hearing took place on 7 and 8 July 2020 by way of a video hearing on the Tribunal Video Platform with the following people in attendance in addition to the two counsel specified below:

Mr David Sheinman – one of the Appellants;

Mr Askar Ansari – Solicitor for the Respondents;

Mr Jawad Malik – Paralegal for the Respondents; and

Mr Jocelyn Ralph – Officer of the Respondents.

A face to face hearing was not held because of the COVID 19 pandemic and because the matters at issue were considered appropriate to be dealt with by of a video hearing.

The documents to which I was referred comprised two bundles to which reference is made in the decision – a documents bundle of 669 pages (the "DB"), containing, inter alia, the relevant closure notices and notices of appeal, certain of the correspondence which had been exchanged between the parties and their representatives in the course of the appeals and certain of the underlying deeds, agreements and financial accounts which gave rise to the subject matter of the hearing, an authorities bundle of 167 pages (the "AB"), setting out the legislation and case law relevant to the hearing, and indices relating to both the DB and the AB.

Mr C McDonnell, counsel, instructed by Howard Kennedy LLP, for the Appellant

Mr James Rivett QC, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

INTRODUCTION

1. This decision relates to appeals made by Mr Ian Shiner (the "First Appellant") and Mr David Sheinman (the "Second Appellant", each of the First Appellant's and the Second Appellant's being referred to hereafter as an "Appellant") against a review decision made by the Respondents on 13 February 2013 in relation to closure notices which were issued by the Respondents on 28 June 2012 to each Appellant under Section 28A of the Taxes Management Act 1970 (the "TMA") in respect of each Appellant's self-assessment returns for the tax years ended 5 April 2006, 5 April 2007 and 5 April 2008 (the "Closure Notices").

2. The history of the appeals is as follows:

(1) on 28 June 2012, the Respondents issued the Closure Notices to the Appellants;

(2) on 18 July 2012, each Appellant notified the Respondents of his appeal against the Closure Notices which related to that Appellant;

(3) on 4 December 2012, the Respondents offered each Appellant a review of the Closure Notices which related to that Appellant;

(4) on 13 February 2013, the Respondents notified each Appellant that the result of their review was that the Closure Notices issued to the relevant Appellant in respect of each of the tax year ended 5 April 2006 and the tax year ended 5 April 2007 would be upheld but that they would make an adjustment to the quantum set out in the Closure Notice issued to the relevant Appellant in respect of the tax year ended 5 April 2008 to reflect work in progress;

(5) on 12 March 2013, the Appellants' representative wrote to the First-tier Tribunal, noting that the amended Closure Notices in respect of the tax year ended 5 April 2008 had not yet been received and notifying the First-tier Tribunal of the Appellants' wish to appeal against the review conclusion; and

(6) on 8 April 2013, the First-tier Tribunal issued a direction under Rule 5(3)(b) of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 (the "Tribunal Rules") that the appeals of the First Appellant and the Second Appellant should be joined.

3. Although it is common ground that the Respondents were correct in their conclusion to the effect that an adjustment should be made to the quantum set out in each Closure Notice in respect of the tax year ended 5 April 2008 to reflect work in progress, there is no mechanism within the TMA for the Respondents to amend the Closure Notices in respect of that tax year to that effect except pursuant to a determination by the First-tier Tribunal on an appeal against the review decision (under Section 50 of the TMA) or pursuant to an agreement between the parties (under Section 54 of the TMA). As there has been no agreement between the parties in relation to those Closure Notices because of the open issue between the parties which is the subject of this decision, the adjustments to those Closure Notices can be given effect only by virtue of this decision. Accordingly, I will take the adjustments into account when reaching my determination in relation to the Closure Notices after setting out my conclusion in relation to the open issue.

4. In brief, that open issue concerns the deductibility of interest of £168,056 which arose in the circumstances described below.

BACKGROUND

5. Each Appellant is a property developer resident in the UK who is subject to income tax in respect of profits arising from certain property developments in Yorkshire.

6. There is no dispute between the parties as to most of the facts which are relevant to these appeals.

7. The facts which are set out below are not in dispute except where I have indicated that to be the case in paragraphs 7(8) and 7(12)(d) below:

(1) the Appellants are business partners who have been the directors of, and shareholders in, various Mark Oliver Homes companies for some 28 years. The group specialises in the construction of housing and many of its projects have been in Yorkshire;

(2) as a result of the risks involved in property development, the Appellants' practice is to place each separate development in a separate entity and then for that entity to contract with an entity in the Mark Oliver Homes group to carry out construction. In that way, any trading difficulties arising out of a particular development can be ring-fenced and the failure of one development will not bring down the group as a whole;

(3) in 2005, the Mark Oliver Homes group was proposing to develop two pieces of land in Bradford – a four acre site at Idlethorpe Way, Thorpe Edge (the "Idle Park Property") and an eleven acre site at Shetcliffe Lane, Bierley (the "Redwood Park Property");

(4) in accordance with advice received by the Appellants from their advisor, PriceWaterhouseCoopers ("PWC"), in relation to the proposed development of those sites:

(a) on 20 April 2005, each Appellant created a settlement in the Isle of Man (the "IOM") in respect of which that Appellant was the life tenant – thus, the First Appellant settled £10 on an IOM resident company named Armourdale Limited ("Armourdale") to hold as trustee of a settlement known as the Ian Shiner 2005 Settlement (the "ISS") and the Second Appellant settled £10 on an IOM resident

company named Parleybrook Limited ("Parleybrook") to hold as trustee of a settlement known as the David Sheinman 2005 Settlement (the "DSS");

(b) on 21 April 2005, Armourdale and Parleybrook, as the trustees of the ISS and the DSS respectively, entered into a partnership in the IOM known as the Redwood partnership (or sometimes as the Redwood Land Partnership) ("Redwood") to carry on a trade of developing properties. Each partner was entitled on behalf of its settlement to 50% of the profits of Redwood; and

(c) as the initial capital of Redwood was to be £1,000, each Appellant made a further contribution to his related settlement of £500 and each of Armourdale and Parleybrook, as the trustees of the ISS and the DSS respectively, contributed £500 to Redwood by way of capital;

(5) on 9 May 2005, the trustees of a settlement known as the Mark Oliver Homes Employee A Sub-Trust (the "EBT") (as the "lender") entered into a loan agreement with Armourdale in its capacity as the trustee of the ISS (as the "borrower") on terms that the lender would lend £225,000 to the borrower (in two separate tranches) and the borrower would pay annual interest equal to the UK Lending Base Rate as published in the Financial Times from time to time during the term of the loan plus two per cent. compounded annually during the term of the loan and would repay the loan in one lump sum on 30 April 2007 (the "First EBT/Armourdale Loan");

(6) on the same day, the EBT (as the "lender") entered into a loan agreement with Parleybrook in its capacity as the trustee of the DSS (as the "borrower") on terms that the lender would lend £225,000 to the borrower and the borrower would pay annual interest equal to the UK Lending Base Rate as published in the Financial Times from time to time during the term of the loan plus two per cent. compounded annually during the term of the loan and would repay the loan in one lump sum on 30 April 2007 (the "First EBT/Parleybrook Loan" and, together with the First EBT/Armourdale Loan, the "First Loans" and each a "First Loan");

(7) each of the First Loans was expressed to be limited in recourse to the assets of the relevant borrower – that is to say, the assets of the relevant settlement – and further provided that the relevant borrower was not required to make any payment in respect of the relevant First Loan unless and until the bank debt described in paragraph 7(9) below had been fully repaid. In the event, that bank debt was not fully repaid until 7 September 2007 and the loans were therefore not repaid until 30 September 2007;

(8) it was intended that the monies advanced under the loan agreements relating to the First Loans would be used to acquire the Idle Park Property from an existing member of the Mark Oliver Homes group. Accordingly, each loan agreement contained a recital to the effect that the borrower "declares that it requires certain finance for the purposes of financing the certain Manx Partnership known as "the Redwood Partnership" of which it is a partner". Consistent with that recital, and expressing the position neutrally for the moment – as it is at the heart of the present dispute – the monies advanced under each loan agreement – less £5,000 in the case of each First Loan - made their way into Redwood and were used by Redwood to discharge part of the purchase price for the Idle Park Property;

(9) Redwood entered into a loan agreement with a bank in order to finance the balance of the purchase price for the Idle Park Property. There is conflicting evidence in the DB as to whether that bank was National Westminster Bank plc ("NatWest") acting as principal on its own account, the Royal Bank of Scotland plc ("RBS") acting as principal on its own account or NatWest acting as agent for RBS. However, as nothing turns on

the identity of the bank for the purposes of this decision, I will refer to it in the rest of this decision as the "Bank". The loan which was made by the Bank to Redwood was secured on the Idle Park Property and guaranteed by the Appellants;

(10) Finally in relation to this first phase of the development, Redwood entered into an agreement with Mark Oliver Homes (Yorkshire) Limited to carry out the construction on the Idle Park Property, in the manner described in paragraph 7(2) above;

(11) on 29 March 2006, very similar arrangements to those described in paragraphs 7(3) to 7(10) above were made in relation to the Redwood Park Property. Thus, the arrangements comprised a loan agreement between the EBT and Armourdale in its capacity as trustee of the ISS (the "Second EBT/Armourdale Loan") and a loan agreement between the EBT and Parleybrook in its capacity as the trustee of the DSS (the "Second EBT/Parleybrook Loan" and, together with the Second EBT/Armourdale Loan, the "Second Loans" and each a "Second Loan"). In the rest of this decision, the First Loans and the Second Loans are referred to as the "Loans" and each of the Loans is referred to as a "Loan";

(12) The key differences between the two arrangements were that:

(a) the amount of each Second Loan was £175,000 (instead of £225,000);

(b) the margin on the two Second Loans over the UK Lending Base Rate as published in the Financial Times from time to time during the term of the Second Loans was two point seven five percent (compounded annually) (instead of two per cent. (compounded annually));

(c) each Second Loan was secured on the Redwood Park Property (whereas the First Loans were unsecured);

(d) there was no £5,000 retention by each of Armourdale as the trustee of the ISS or Parleybrook as the trustee of the DSS before the monies made their way into Redwood. Instead, the full principal amounts of the Second Loans made their way into Redwood (again, putting the position neutrally for the reason mentioned in paragraph 7(8) above);

(e) each Second Loan was drawn down in a single tranche on 3 April 2006 (instead of in two tranches);

(f) each Second Loan was repayable together with compounded accrued interest on 31 March 2009 (instead of 30 April 2007 or 30 September 2007); and

(g) each Second Loan was limited in recourse to the Redwood Park Property (whereas the First Loans were limited in recourse to the assets within the relevant settlement) and, unlike the arrangements in relation to the Idle Park Property, there was no reference in the Second Loans to any bank debt or provision within the loan agreements relating to the Second Loans for payments in respect of the Second Loans to be deferred behind any bank debt;

(13) while it is assumed by both sides in the dispute that there was bank funding from RBS to Redwood in relation to the Redwood Park Property, no evidence was provided at the hearing in relation to the terms of this funding. However, it appears from a description which appears in note 8 in each of the signed accounts of Redwood for the financial year 1 April 2006 to 31 March 2007 bearing the date 31 July 2007 (the "Redwood 2007 Accounts") and the unsigned and undated draft accounts of Redwood for the financial year 1 April 2007 to 31 March 2008 (the "Redwood 2008 Draft Accounts") that the terms of the funding may have been similar (but not identical) to the

terms of the funding which was provided by the Bank to Redwood in relation to the Idle Park Property; and

(14) until it was removed from its role at some point after the tax year ended 5 April 2008 but prior to 8 November 2010, a trustee company resident in the Isle of Man, Abacus Trust Company Limited ("Abacus'), managed each of Armourdale, Parleybrook, the ISS, the DSS and Redwood and it was Abacus who were responsible for providing the directors of each of Armourdale and Parleybrook and for attending to the preparation of the accounts of the ISS, the DSS and Redwood.

8. The events which have led to the present appeals are long and protracted. They have included judicial review proceedings before the High Court and the Court of Appeal. I propose to say very little about those events and those proceedings as they have no relevance to the issue which I am required to resolve in this decision.

9. However, by way of summary, the Appellants initially contended that they were not liable to income tax on the trading profits of Redwood because of the provisions of the UK/IOM Double Taxation Arrangement which prevented the UK from taxing the income of a Manx enterprise (notwithstanding that the income was beneficially owned by a UK resident) except to the extent that the income was attributable to a UK permanent establishment. The effect of those provisions had been counteracted by legislation passed by Parliament - initially in 1988 and then subsequently extended retrospectively in 2008 – and the Appellants unsuccessfully sought to challenge the efficacy of that counteraction in their case under EU law principles. In addition, the Appellants at one point sought to argue that, as the income of Redwood in the relevant tax years was incapable of distribution to them during those tax years, they had no entitlement to that income until it was distributed, but the Appellants subsequently withdrew that ground of appeal.

10. As a result of the history briefly described above, the Appellants now accept that they are liable to income tax on their respective shares of the trading profits of Redwood in the tax years in question and therefore that the only remaining issue is the quantum of those trading profits in each relevant tax year.

THE RELEVANT LAW

11. As the parties are agreed in relation to most of the law which is relevant to these appeals, I do not propose to set that law out in any detail. It suffices for present purposes to say the following:

(1) as:

(a) each Appellant was the settlor of a settlement in respect of which he was entitled to the income as it arose, and that income included the trading profits of Redwood; and

(b) the profits of a trade arising to a UK resident are chargeable to income tax no matter where the trade is carried on,

each Appellant is liable to income tax on the share of the trading profits of Redwood to which his settlement was entitled;

(2) the taxable profits of each Appellant in respect of each tax year are to be determined by calculating the amount which would have been the taxable profits of Redwood for that tax year if Redwood had been a UK resident individual and then allocating to the Appellant in question its share of those taxable profits as so calculated, such share's being

determined in accordance with the profit-sharing arrangements between the partners for the basis period in respect of that tax year;

(3) in carrying out the calculation described above, the taxable profits of Redwood are to be calculated in the first instance by reference to its accounts for the basis period prepared in accordance with generally-accepted accounting practice but subject to certain specific statutory rules, which include the fact that expenses which are capital in nature and expenses which are not incurred wholly and exclusively for the purposes of the trade are not deductible; and

(4) subject to certain specific rules to cover the situation in which the trade starts or commences - which are pertinent to some extent in this case because the trade of Redwood commenced only in May 2005 - the basis period for a tax year is the date in the relevant tax year by reference to which the trader's accounts are drawn up.

SUMMARY OF THE DISPUTE

12. I have already mentioned in paragraphs 2(4) and 3 above that one of the issues which was in dispute between the parties following the issue of the Closure Notices related to adjustments to the profits of Redwood which were subject to tax in the hands of the Appellant in the tax year ended 5 April 2008 by reference to work in progress and that that issue has now been agreed between the parties.

13. However, another issue between the parties – and the one which is the subject of this decision - was whether the interest which was payable in connection with the four Loans is deductible in computing the profits in respect of which the Appellants are subject to tax.

The first question

14. In that regard, it is common ground that interest is deductible in computing the trading profits of a partnership if that interest is incurred by the partnership and properly reflected in the partnership's accounts provided that the interest is not a capital expense and is incurred wholly and exclusively for the purposes of the partnership's trade. It is for that reason that the Respondents have accepted that the interest which was paid by Redwood in respect of the loans which were made to it by the Bank is so deductible.

15. However, the parties are at odds in relation to whether the interest which was payable in connection with the four Loans also falls within that description and therefore falls to be treated in exactly the same way as the interest which was paid by Redwood to the Bank.

16. Mr McDonnell, on behalf of the Appellants, submitted that the Loans should be regarded for tax purposes as loans to the partnership itself because, as an IOM partnership does not have legal personality, the monies advanced to the partners (Armourdale and Parleybrook, as trustees for their respective settlements) were effectively advanced to the partnership and therefore the interest which was paid by the partners was interest paid by the partnership.

17. In contrast, Mr Rivett, on behalf of the Respondents, submitted that the Loans had been made solely to the partners themselves and not to the partnership and were then applied by the partners in making capital contributions to the partnership. As such, the interest was paid by the partners and not by the partnership and could not properly be shown in the accounts of the partnership for any of the basis periods in question.

18. Thus, the first question which I need to determine is whether, on the facts as found and the correct application of the relevant legal principles, the Loans should be regarded for tax purposes as having been made to the partnership or instead solely to the partners outside the

partnership. This first question is a mixed question of fact and law – namely, what actually happened as a matter of fact and how should that be analysed as a matter of law?

19. If the conclusion to the first question is that the loans were made to the partnership, then further issues need to be addressed before a deduction can be allowed, such as was the interest on the loans actually paid by the partnership, has that interest properly been reflected in the accounts of the partnership and could relief for that interest be denied on the basis of one of the statutory rules mentioned above – for example because it was a capital expense or was not incurred wholly and exclusively for the purposes of the partnership's trade.

The second question

20. If the conclusion to the first question is that the Loans should be regarded for tax purposes as having been made to the partners outside the partnership and not to the partnership, then that leads to the second question which I need to address, which is as follows. Mr McDonnell submitted that, even if the Loans should be regarded for UK tax purposes as having been made to the partners and not to the partnership, with the result that the interest on the Loans was paid by the partners and not by the partnership, the decision of the Court of Appeal in *Vaines v The Commissioners for Her Majesty's Revenue and Customs* [2018] EWCA Civ 45 ("*Vaines*") is authority for the proposition that an expense which is incurred by a partner in his personal capacity but for the purposes of the trade of a partnership can nevertheless qualify as a deductible expense in computing the partnership profits as long as it is not capital in nature and passes the wholly and exclusively test.

21. In reply, Mr Rivett submitted that the decision in *Vaines* was dealing with circumstances where a partner, in the course of carrying on the trade of the partnership of which he or she was a member, incurred an expense which would have been a deductible expense in computing the partnership profits but that that case had no application in relation to interest which was incurred by a partner on a borrowing taken out to finance his or her investment in the partnership. In effect, said Mr Rivett, it is necessary to recognise that a partner in a partnership of which he or she is a member plays two completely separate roles in relation to that partnership – the partner is at once both an investor in the partnership (in much the same way as a shareholder is an investor in a company of which he or she is a member) and, except in the case of a limited partner, also a participant in actively carrying on the partnership trade. A loan made to the partner to finance the partner's capital in the partnership relates to the first of those roles whereas the principle described in *Vaines* is applicable only to the second.

22. Thus, the second question which I need to determine if I find in favour of the Respondents in relation to the first question is whether, as a matter of law, interest which is incurred by a partner in his or her personal capacity on a loan taken out to finance his or her capital contribution to the partnership might nevertheless be deductible under the principle set out in *Vaines*. This second question is solely a question of law.

THE EVIDENCE

23. The evidence at the hearing consisted of various documents in the DB, coupled with the testimony of the Second Appellant.

24. In addition to the terms of the loan agreements pursuant to which the Loans were advanced – the material provisions of which I have summarised in paragraph 7 above - the documents in the DB which are most relevant to this decision were as follows:

(1) advice on the structure from PWC dated 18 October 2004 (the "PWC Advice");

(2) the agreement establishing Redwood between Armourdale (as trustee of the ISS) and Parleybrook (as trustee of the DSS) dated 21 April 2005 (the "Partnership Agreement");

(3) the signed accounts of Redwood for the financial year 21 April 2005 to 31 March 2006 bearing the date 28 March 2007 (the "Redwood 2006 Accounts");

(4) the Redwood 2007 Accounts which, as noted in paragraph 7(13) above, were signed and dated 31 July 2007;

(5) the Redwood 2008 Draft Accounts which, as noted in paragraph 7(13) above, were unsigned and undated;

(6) the unsigned purportedly final accounts of Redwood for the financial year 1 April 2007 to 31 March 2008 bearing the date 27 February 2012 (the "Redwood 2008 Final Accounts");

(7) the unsigned draft accounts of Redwood for the financial year 1 April 2008 to 31 March 2009 bearing the date 8 November 2010 (the "Redwood 2009 Draft Accounts");

(8) the unsigned purportedly final accounts of Redwood for the financial year 1 April 2008 to 31 March 2009 bearing the date 27 February 2012 (the "Redwood 2009 Final Accounts");

(9) the signed accounts for each of the ISS and the DSS for the financial year 20 April 2005 to 31 March 2006 bearing the date 1 October 2007 (each such set of accounts' being "Settlement 2006 Accounts");

(10) draft heads of terms for a loan to be made by the Bank to Redwood to finance the purchase and development of the Idle Park Property and guarantees to be provided by the First Appellant in relation to the debt of Armourdale and the Second Appellant in relation to the debt of Parleybrook;

(11) letters from each of Armourdale and Parleybrook to the Respondents dated 6 January 2006 describing the transactions referred to in paragraphs 7(3) to 7(10) above (each such letter's being a "Trust Letter");

(12) a letter dated 23 April 2008 from Nyman Libson Paul, a firm of chartered accountants ("Nyman"), to the Respondents enclosing the Partnership Agreement, the Settlement 2006 Accounts in relation to the ISS and the Redwood 2006 Accounts. The Second Appellant in his testimony said that it was safe to assume that an identical letter would have been sent by Nyman to the Respondents in relation to the Second Appellant and the DSS. The two letters are referred to hereafter as the "Nyman 2008 Letters";

(13) the tax returns for each Appellant in respect of the tax year ended 5 April 2008 (the "2008 Tax Returns")

(14) a letter dated 16 October 2012 from the Respondents to Nyman asking for further information about the structure (the "Respondents' Letter"); and

(15) a letter dated 26 November 2012 from Nyman to the Respondents in response to the Respondents' Letter attaching:

> (a) a schedule (the "Interest Schedule") showing how the figure for non-bank interest of £168,056 which appeared in the Redwood 2008 Final Accounts had been calculated; and
>
> (b) statements from Abacus (the "Abacus Statements") showing the various cash movements which were made in connection with the Loans to each of the ISS and

the DSS and the movement of the proceeds of the Loans to Redwood (the "Nyman 2012 Letter").

25. In my view, the key features of the above documents in the context of this decision are as follows:

(1) the PWC Advice set out the proposed generic structure of the scheme and, in so doing, made no mention of the manner in which the partnership should be funded in order to acquire the relevant property;

(2) the Partnership Agreement contained provisions relating to the partnership accounts, the capital contributions to the partnership and loans by the partners to the partnership. Clause 5 stated that it was the responsibility of both partners to ensure that proper books of account as to the affairs of the partnership were kept and that a profit and loss account and balance sheet was required to be prepared at the end of each financial year of the partnership in accordance with "Accounting Standards" – effectively, generally-accepted accounting practice in the IOM. Clause 6 stated that each partner was required to make an initial capital contribution to the partnership of £500 and that a capital account should be maintained for each partner in which all future contributions by, and repayments of capital to, the relevant partner should be recorded. It also provided that no interest would accrue on the capital accounts and that any money lent to the partnership by a partner (as opposed to being contributed by that partner by way of capital) would carry interest at the rate of two per cent. above the base rate from time to time of the Royal Bank of Scotland International Limited (or, in the absence of that, RBS) which, if unpaid, would be compounded quarterly;

(3) the white box for "Any other information" in each of the 2008 Tax Returns was completed on the basis that Redwood had made a profit in the financial year comprising the basis period for the tax year ended 5 April 2008 of £3,123,637 and that figure corresponded with the profit figure shown in the Redwood 2008 Draft Accounts but not the profit figure shown in the Redwood 2008 Final Accounts;

(4) the Redwood 2006 Accounts recorded such part of the proceeds of the First Loans as had made their way into Redwood in the relevant financial year - ie £440,000 in aggregate - in the partners' capital accounts as "Capital contributions in the period"- in note 9. The same amounts were recorded in the "Balance brought forward" of the capital accounts in the Redwood 2007 Accounts - in note 9 - and note 9 in the Redwood 2007 Accounts also recorded the proceeds of the Second Loans which made their way into Redwood as "Contributions during the year". In neither of those accounts were any of the First Loans or the Second Loans recorded within creditors in note 8. Consistent with that treatment, none of the interest accruing on any of the First Loans or the Second Loans was recorded within interest payable in note 3 in either of those accounts;

(5) precisely the same treatment to that described in paragraph 25(4) above was adopted in the Redwood 2008 Draft Accounts - see notes 3, 8 and 9 in those accounts;

(6) however, the accounting position had changed by the time that the Redwood 2009 Draft Accounts were prepared on 8 November 2010. It is clear from those accounts that Armourdale and Parleybrook had by then been replaced as trustees of the ISS and the DSS respectively and that Nyman had taken over responsibility for preparing the accounts of the partnership. In those accounts:

(a) note 6 included, in "Other loan interest payable", the interest accruing on the Second Loans in the relevant financial year;

(b) the creditors figures recorded in note 9 included the Second Loans as "Other loans";

(c) no mention was made of the partners' respective capital accounts. Instead, note 10 merely recorded "Partners' Current Accounts", in apparent contravention of the requirements of clause 6 of the Partnership Agreement as mentioned above; and

(d) equally significantly, within the comparative figures for 2008 in note 9, a figure of £752,191 appeared against "Other loans" when that figure had not appeared in the Redwood 2008 Draft Accounts;

(7) each of the Redwood 2008 Final Accounts and the Redwood 2009 Final Accounts prepared as at 27 February 2012 were prepared on a similar basis to the basis adopted in preparing the Redwood 2009 Draft Accounts. In other words, to the extent that they remained outstanding at the end of the relevant financial year, the Loans were taken into account within creditors in note 9 (and not the partners' current accounts in note 10) and the interest on the Loans which had accrued prior to the end of the relevant financial year was taken into account as "Other loan interest payable" within the finance expenses in note 6;

(8) it is apparent from the fourth paragraph of the Respondents' Letter that, in its letter to the Respondents of 27 September 2012 (which was not included in the DB), Nyman had informed the Respondents that Abacus had made fundamental errors in preparing the Redwood 2008 Draft Accounts. However, in response to the Respondents' request in that paragraph of the Respondents' Letter for copies of the correspondence between Nyman and Abacus in respect of those errors, Nyman said that it had not corresponded with Abacus at all on that subject (see the second paragraph in the Nyman 2012 Letter); and

(9) each of the Settlement 2006 Accounts recorded the First Loan which had been made to the relevant settlement within the "Loan" item at note 3 and the relevant settlement's investment in Redwood within "The Redwood Land Partnership – Capital account" at note 2. However, no provision was made within the expenses section of the income and expenditure account for any accrual on the First Loan.

26. In my view, the main points arising out of the testimony of the Second Appellant were as follows:

(1) although the Second Appellant was a qualified accountant, he had not practised as such for over twenty years and he accepted that there had been many changes in accounting practices over that period;

(2) in his view, the advice of PWC in relation to the structure had been that, in order for the structure to achieve its desired aim – the exclusion from income tax of the trading profits of Redwood – the monies advanced by the EBT to each of Armourdale as trustee of the ISS and Parleybrook as trustee of the DSS needed to be on-lent by those entities to Redwood, as opposed to being contributed by way of additional capital into Redwood and therefore that is what must have occurred;

(3) however, Abacus, in preparing the accounts of Redwood and the two settlements, in its capacity as manager of the entities involved in the structure, had failed to record properly the events which had occurred in accordance with the PWC advice and therefore, when this error had been discovered, the Redwood 2008 Draft Accounts had been amended to record the interest which had accrued on the on-loans by the two settlements to the partnership over the period from inception until 31 March 2008;

(4) Nyman had, throughout the period in which the structure existed, been his and the First Appellant's accountants and it was for that reason that Nyman had sent the Nyman 2008 Letters, with their enclosures, to the Respondents. However, Nyman did not get involved in looking in any detail at the accounting treatment of the entities within the structure until Abacus had been removed as manager, some time in 2009. It followed that Nyman could not fairly be regarded as having checked and approved the accounting treatment adopted by Abacus when it sent the Redwood 2008 Draft Accounts to the Respondents as an enclosure to the Nyman 2008 Letters;

(5) the Second Appellant admitted that the PWC Advice did not mention the manner in which the partnership in the generic structure was to be financed. However, he went on to say that he was in possession of other papers demonstrating that PWC's advice had been as described in paragraph 26(2) above. Nevertheless, when he was asked to provide those papers at the hearing, he was unable to do so. The only advice on that subject that he could find (which he read out at the hearing) referred to the two settlements' making "investments" in the partnership;

(6) the Second Appellant also conceded that:

(a) he had had no direct involvement with any of the arrangements in the structure. He was not a party to any of the agreements or a director of any of the entities which were; and

(b) the entities involved in the structure were managed by Abacus, a professional trust company, which must be assumed to have taken its role seriously and to have taken care over the preparation of the accounts of the entities;

(7) however, he pointed that mistakes do happen and that, despite the above, Abacus had made errors in the preparation of those accounts; and

(8) nevertheless, he was able to provide no justification or basis for the allegation that such errors had been made or for the proposition that the Redwood 2008 Final Accounts were correct in the manner in which they accounted for the Loans.

FINDINGS OF FACT

27. Before setting out my findings of fact in this case, there are two preliminary points which I should make.

28. The first is to observe that the burden of proof in this case is on the Appellants. It is for them to show that the Respondents have erred in preparing the Closure Notices and not for the Respondents to prove that the Closure Notices are correct. In terms of the relevant facts, the Appellants and their adviser, Mr McDonnell, have provided two alternative (and contradictory) analyses. Mr McDonnell submitted that the Loans in this case were made directly to the partnership whereas, in his testimony, the Second Appellant expressed the view that the Loans were made to the settlements and that the settlements then on-lent the proceeds of the Loans to the partnership. In order for either one of those descriptions to prevail, the Appellants need to satisfy me that the relevant description is, on the balance of probabilities, in accordance with the facts.

29. The second point is an observation in relation to the evidence that the Appellants have provided in connection with the appeals. Given the nature of the factual dispute, and the points of law which are involved in this case, I would have expected to hear the testimony of someone who was involved in the implementation of the structure at the relevant time – such as a relevant staff member of Abacus – and someone who was involved in the decision to change the accounting treatment of the partnership – such as a relevant staff member of Nyman. In

addition, I would have expected to hear testimony from an expert witness in relation to the absence of legal personality of a general partnership in the IOM such as Redwood (which is fundamental to Mr McDonnell's submissions in relation to the first question) and an expert witness in relation to the correct accounting treatment of the transactions under generally-accepted accounting practice in the IOM, including, in particular:

(1) the justification for including within the Redwood 2008 Final Accounts interest which had accrued on the First Loans and the Second Loans in earlier financial years; and

(2) the similarities and differences between generally-accepted accounting practice in the IOM and generally-accepted accounting practice in the UK.

None of the above evidence was forthcoming. Instead, the only testimony with which I was provided was that of the Second Appellant, who had no direct involvement in the transactions and is not a practising accountant and whose opinion as to what had happened in relation to the structure was inconsistent with the submissions of Mr McDonnell.

30. There were also significant gaps in the documentary evidence with which I was provided. For example, there were no accounts for the ISS or the DSS in respect of the financial years ending 31 March 2007 or 31 March 2008 and the Redwood 2007 Accounts were provided on the first day of the hearing only after I requested them. In addition, I was not provided with the loan agreement between the partnership and the Bank for the purchase of the Idle Park Property – I saw only the draft heads of terms – or with any documentation at all in relation to the bank financing to the partnership for the purchase of the Redwood Park Property.

31. In the circumstances, it is not surprising that I have reached the conclusion that not only have the Appellants failed to satisfy me that, on the balance of probabilities, the Respondents' view of the facts is incorrect but that, in my view, for the reasons which follow in paragraph 34 below, there is no reasonable basis for reaching a conclusion on the facts which is contrary to the one which the Respondents have reached.

32. In short, I agree with the Respondents that what happened in this case is that:

(1) each Loan was made by the EBT to the trustee of the relevant settlement on behalf of that settlement, as specified in the relevant loan agreement;

(2) each trustee, on behalf of the relevant settlement, then used the proceeds of that Loan – apart from a retained amount of £5,000 in the case of each First Loan - to make an additional capital contribution to Redwood; and

(3) consequently, all of the interest on the Loans was paid by the trustees on behalf of their respective settlements and those interest payments were funded by distributions from Redwood.

33. My reasons for reaching the above conclusion are as follows:

(1) the starting point is each loan agreement, which referred to the fact that the borrower from the EBT was the relevant trustee "as trustee of [the relevant settlement]". This indicates that each trustee company was borrowing the money not in its capacity as a partner of Redwood but instead in its capacity as trustee of the relevant settlement. In other words, immediately after the relevant Loan was advanced, the proceeds of the Loan were part of the assets of the settlement and not part of the assets of Redwood. A further step would be required before the proceeds could be said to form part of the partnership assets. This conclusion is reinforced by the terms of Clause 3 of each loan agreement, which required the EBT to make its advance or advances to an account of the relevant settlement and not to an account of Redwood. It is also reinforced by the second recital

to each loan agreement to the effect that "the Borrower declares that it requires certain finance for the purposes of financing the certain Manx Partnership known as "the Redwood Partnership" of which it is a partner". Although Mr McDonnell claimed that that language tended to support his analysis that the Loan proceeds became partnership assets as soon as they were advanced, in my view the opposite is the case. The words "for the purposes of financing" seem to me to make it clear that an additional step was required before the Loan proceeds became part of the partnership assets;

(2) that additional step might have been a capital contribution to the partnership or an on-loan by each partner to the partnership (as the Second Appellant suggested in giving his evidence). All of the available evidence suggests that it was the former. In the first place, the Abacus Statements referred to the fact that the onward payment of the First Loan proceeds amounted to an "investment" in Redwood, whilst the onward payment of the Second Loan proceeds amounted to a "Contribution" to Redwood. Then there is the fact that the Partnership Agreement expressly envisaged that additional capital contributions would be made from time to time by the partners – see Clauses 6.4 and 6.5 of the Partnership Agreement. It is true that Clause 6.8 also envisaged that loans might be made by the partners to the partnership from time to time but the interest calculation set out in that clause is different from the interest calculation which has given rise to the interest in respect of which the present claims are being made. (Although the margin of two per cent. corresponded to the margin applicable on the First Loans:

(a) the margin on the Second Loans was not two per cent. but two point seven five per cent.;

(b) the provisions in the Partnership Agreement require quarterly compounding whereas the terms of the loan agreements refer to annual compounding; and

(c) in the case of all of the Loans, the relevant margin was added to a different base rate from the base rate set out in Clause 6.8 of the Partnership Agreement.)

Thus, the evidence demonstrates that the interest in respect of which relief is being claimed was not calculated in accordance with Clause 6.8 of the Partnership Agreement;

(3) the next point is that the settlements and Redwood were being managed at the time when the transactions occurred by a professional trustee company (Abacus) which, in the absence of any evidence to the contrary, must be assumed to have taken its obligations seriously. Although Nyman alleged in its letter to the Respondents of 27 September 2012 (which was not included in the DB) that Abacus had made fundamental errors in preparing the accounts in the past, Nyman made it clear, in its response to the Respondents' request in the fourth paragraph of the Respondents' Letter for copies of the correspondence between Nyman and Abacus in respect of those errors, that it had not corresponded with Abacus at all on that subject (see the second paragraph in the Nyman 2012 Letter). The absence of any correspondence between Nyman and Abacus in relation to the alleged accounting errors, coupled with the fact that it was Abacus and not Nyman who were responsible for managing the transactions at the time when they occurred (and should therefore be presumed to have understood the nature of what occurred more accurately than Nyman several years later) and the absence of testimony from anyone at Abacus or Nyman, leaves me unconvinced that any such errors were made;

(4) similarly, even accepting the Second Appellant's testimony to the effect that Nyman were not acting for the settlements or the partnership when they sent the Nyman 2008 Letters to the Respondents, it is noteworthy that, in each of those letters, Nyman

enclosed both the Redwood 2006 Accounts and the Settlement 2006 Accounts which related to the relevant settlement and, in both such letters:

(a) Nyman mentioned in paragraph 1 that it was the settlement which had entered into the relevant First Loan; and

(b) Nyman noted in paragraph 5 that the acquisition of the Idle Park Property had been financed by the relevant First Loan and a loan facility from RBS.

It is inconceivable that Nyman would have included that information in the Nyman 2008 Letters if that was not Nyman's understanding at that time of the events which had occurred in 2005;

(5) the one slight caveat which I would make in relation to the points made in paragraphs 33(3) and 33(4) above is that neither of the Settlement 2006 Accounts includes an accrual in respect of the interest on the First Loans over the period to 31 March 2006. Although no expert accounting evidence was presented to me at the hearing, I would have expected the income and expenditure account in each set of Settlement 2006 Accounts to have reflected that accrued liability. Nevertheless, I do not regard the absence of that accrual as meaningful in this context, given:

(a) the absence of expert accounting evidence to confirm the expectation expressed above;

(b) the weight of the other evidence in this paragraph 33 which suggests that the Loans were obligations of the settlements; and

(c) the fact that Mr McDonnell in his submissions did not make anything of the absence of the accrual in those accounts;

(6) I then note that each of the Redwood 2006 Accounts and the Redwood 2007 Accounts were produced on the basis that I have described in paragraph 32 above and that each of those accounts were signed on behalf of the partners. Neither of those accounts has ever been restated and I can see no reason why they should be regarded as being incorrect. It is clear from Clause 5 of the Partnership Agreement that both partners had a responsibility to ensure that proper books of account were kept and that proper accounts of the partnership were produced in relation to each financial year. In the absence of any evidence to the contrary, it must be assumed that the partners were fulfilling their duties in signing the accounts for those two years in the form which they took;

(7) an identical approach was taken in the Redwood 2008 Draft Accounts and in the white box for "Any other information" in each of the 2008 Tax Returns, again suggesting that the analysis set out above is correct;

(8) similarly, in each Trust Letter, each partner informed the Respondents that it had entered into its First Loan with the EBT and used the proceeds to make an investment in the partnership; and

(9) finally, when the Second Appellant was asked to explain the reasons underlying the change in accounting treatment which was made on 8 November 2010 when the Redwood 2009 Draft Accounts were prepared, the only explanation he was able to give was that the advice on the structure from PWC required that loans were made to the partnership by the partners. As Mr Rivett pointed out at the hearing, even if PWC had given that advice, that would not have been of meaningful assistance to the Appellants because the relevant issue is not what PWC advised should be done but rather what was actually done. However, in any event, the Second Appellant was unable to provide me

with any evidence that PWC had given that advice. And it is hard to see why loans to the partnership (as opposed to capital contributions) could have been thought to be a necessary part of the structure in any event as the efficacy of the structure depended on an exemption from income tax on the profits of the partnership as a whole. In that context, whether the partnership was funded by way of debt or funded by way of equity would seem to have no relevance.

34. In conclusion, I consider that the events which occurred in relation to the funds which were provided to the partnership were as described in paragraph 32 above and that therefore, in this respect, the Redwood 2008 Final Accounts were prepared on an incorrect basis whereas the Redwood 2006 Accounts, the Redwood 2007 Accounts and the Redwood 2008 Draft Accounts were not. It is idle to speculate on the reasons why the change in accounting treatment was made in 2010 but it suffices to say that I do not accept that the revised accounting treatment was correct.

DISCUSSION

The first question

35. The first of the two questions which I am required to address in this decision is whether, on the facts as found and the correct application of the relevant legal principles, the Loans were made to the partnership or to each of the partners itself outside the partnership. As I noted in paragraph 18 above, this first question is a mixed question of fact and law – namely, what actually happened as a matter of fact and how should that be analysed as a matter of UK tax law?

36. My view on the facts is set out in paragraphs 31 to 34 above. In the light of the findings of fact set out in those paragraphs, the Appellants would be entitled to succeed in relation to the first question only if a borrowing by a partner to finance a capital contribution into a general partnership in the IOM of which it is a member should be analysed, as a matter of UK tax law, as a borrowing by the partnership itself.

37. I can see no basis in UK tax law for that proposition.

38. Mr McDonnell's submission to that effect was founded on the fact that a general partnership in the IOM has no legal personality and is therefore transparent for UK tax purposes. I was provided with no expert evidence on that question although Mr McDonnell did provide me during the course of the hearing with a document issued by the Isle of Man Finance (part of the Isle of Man Treasury) and a copy of the Isle of Man Partnership Act 1909, both of which tended to support the proposition that an IOM general partnership is akin to an English general partnership in lacking legal personality. Despite the paucity of evidence on the point, Mr Rivett said that, solely for the purposes of this case and without prejudice to the Respondents' position in any other case, he was content on behalf of the Respondents to accept that an IOM general partnership should be treated as transparent for UK tax purposes. I am also happy to proceed on the basis that this is the case.

39. On the basis of that assumption, it follows that all of the assets and liabilities of Redwood were assets and liabilities of each partner in Redwood. However, it most certainly does not follow from that assumption that the converse is also the case and that all of the assets and liabilities of each partner in Redwood were also assets and liabilities of Redwood. Each partner had an existence which was independent of Redwood and was perfectly capable of having (and did in fact have) assets and liabilities which were not assets and liabilities of Redwood. It follows that the mere fact that the partnership in this case was transparent for UK tax purposes does not mean that interest paid by each partner in the partnership on borrowings taken out by that partner to finance its capital contributions to the partnership should be treated as having

been paid by the partnership. Each partner – namely, the trustee on behalf of the settlement of which it was trustee – was perfectly capable of entering into transactions in its own right and without those transactions' being regarded as transactions of the partnership.

40. Putting this another way, and reverting to a point which I made in paragraph 33(1) above, immediately after the time when each of the Loans was made, the proceeds of the relevant Loan belonged beneficially to the settlement quite independently of the partnership and not to the partnership. A further step was required before the proceeds became assets of the partnership.

41. For completeness, I should add that, in my view, the mere fact that the second recital to each loan agreement referred to the relevant partner's intention to use the proceeds of the Loan to finance the partnership did not mean that the Loan proceeds belonged beneficially to the partnership at the time when they were advanced. It is a question of IOM law – which was the law governing the loan agreements - as to whether the terms of that recital gave rise to a contractual obligation on the relevant partner to use the Loan proceeds in the manner specified. It seems to me to be unlikely that that was the case as the statement is contained in a recital and not in an operative part of the relevant loan agreement and, in any event, it is merely a statement of intention and falls short of being an express warranty, representation or covenant such as the ones in Clauses 7 and 8 of each loan agreement. However, even if the terms of that recital were to be analysed under IOM law as amounting to such a contractual obligation, that obligation was owed to the EBT as lender and any failure to use the proceeds in that manner would merely have given rise to a claim for breach of contract by the EBT. It would not affect the fact that the proceeds of the relevant Loan belonged beneficially to the relevant settlement as borrower and not to Redwood immediately after they were advanced.

42. The above is sufficient of itself to dispose of the first question in the Respondents' favour. However, I did just want to mention an aspect of these appeals which demonstrates that the Appellants themselves have accepted that the Loans were made to the settlements and not to the partnership.

43. It has always been part of the Appellants' case that £5,000 of each First Loan was retained by the relevant settlement and was not contributed to the partnership. It is hard to understand how that approach is consistent with the proposition that the relevant Loans should be regarded as having been made to the partnership directly. But, leaving that aside, according to the Interest Schedule which was attached to the Nyman 2012 Letter, the interest of £168,056 which is the subject of the appeals was made up of an accrual on the second tranche of the First Loans to 31 March 2008 of £110,836.01 and an accrual on the Second Loans to 31 March 2008 of £57,219.99. That schedule also records an accrual on the first tranche of the First Loans to 9 November 2007 of £9,135.11. However, no claim for relief has been made in respect of that interest. Surely if the borrowings made by the settlements should be treated automatically for UK tax purposes as borrowings made by Redwood, shouldn't that interest have been included in the claims as well? Whilst it is understandable that interest accrued on £10,000 of that first tranche might be excluded from the claim, because of the £10,000 retention within the two settlements referred to above, there appears to be no logical reason why interest on the balance of that first tranche should have been excluded. After all, there is no difference in principle between £40,000 of that first tranche and the second tranche of the First Loans.

44. In conclusion on the first question, I agree with the Respondents that the UK tax analysis of the events which occurred was that the interest on the Loans was not paid by the partnership but was instead paid by the partners outside the partnership.

The second question

45. It follows from the above conclusion that the interest is not deductible in computing the trading profits of the partnership unless Mr McDonnell is able to succeed in relation to the second question, which is based on the decision in *Vaines*.

46. To be clear, Mr McDonnell did not say that he was relying on the ratio of the decision in *Vaines*. In that case, the taxpayer was denied relief in calculating the income tax on his share of the profits of one partnership in respect of a payment which he had made to settle a claim made against him in relation to his role in another partnership on the basis that the payment was not made wholly and exclusively for the purposes of the first-mentioned partnership's trade.

47. However, Mr McDonnell sought instead to rely on a point to which Lord Justice Henderson alluded in the course of his judgment, to the effect that an expense which is incurred by a partner wholly and exclusively for the purposes of the partnership's trade can still be deducted in calculating the income tax on the relevant partner's share of the profits of that trade even though that expense has not been incurred by the partnership itself and has not been recorded as an expense in the accounts of the partnership. Mr McDonnell said that, by parity of reasoning, even if the interest paid on the Loans in this case were to be regarded as having been paid by the settlements themselves and not by the partnership, that interest was demonstrably incurred wholly and exclusively for the purposes of the partnership's trade because the Loans were taken out in order to finance the purchase by the partnership of its trading assets – as recorded in recital 2 of each loan agreement - and therefore the interest paid by each settlement was deductible in computing the tax which was due by the Appellant who was the settlor of that settlement on that settlement's share of the partnership's profits.

48. I am afraid that I do not agree with Mr McDonnell's submission on this point either.

49. I would start by observing that the sole purpose of the trustee of each settlement in entering into the relevant loan agreements was to finance that settlement's capital contribution to the partnership. It was not an expense which the settlement was incurring wholly and exclusively for the purposes of the partnership's trade. Of course, had the Loans been made to the partnership directly, or had the proceeds of the Loans been on-lent by the partners to the partnership, such that the partnership had itself incurred borrowings to finance the purchase of the trading assets, then those borrowings would undoubtedly have been incurred wholly and exclusively for the purposes of the partnership's trade and the interest on those borrowings would, provided that it was reflected in the partnership's accounts, have been deductible in computing the profits of that trade. But I do not believe that, in examining the purpose for which the Loans were drawn down, it is appropriate to ignore the intervening step of the capital contributions which were made by the settlements and simply treat the purposes of the partnership as the purposes of the partners.

50. Putting this another way, I agree with Mr Rivett's distinction between expenses which a partner incurs in its capacity as an investor in a partnership and expenses which that partner incurs in pursuing the trading purposes of that partnership. Expenses falling within the second category are the ones to which Lord Justice Henderson was referring in his judgment in *Vaines*. In my view, his judgment has no relevance to expenses falling within the first category.

51. I consider that support for the above conclusion can be found in two points.

52. The first is to address the hypothetical position which would have pertained if each partner, instead of making a capital contribution to the partnership with the proceeds of each Loan (as I have found to be the case) had instead used those proceeds to make an interest-bearing on-loan to the partnership (as the Second Appellant contended in his evidence). In that case, the interest paid by the partnership on the on-loans by each partner would, assuming that it was reflected in the partnership's accounts, be deductible in computing each partner's share

of the partnership profits and, on the basis of Mr McDonnell's submission, so too would be the interest paid by the partner itself. There would of course also be an inclusion in the income of each partner for the interest paid to it by the partnership. So, within each partner, there would be two deductions and one inclusion. Could it really be said in that case that the borrowing taken out by the partner which was generating investment income for the partner (in the form of interest income from the partnership) had been incurred wholly and exclusively for the purposes of the partnership's trade? Would it not be more accurate to say that the borrowing by the partner in that case had been incurred for the purpose of deriving interest income from the on-loan to the partnership? And, if that is the case, the same must be true if, instead of using the proceeds of a Loan to make an on-loan to the partnership, the relevant partner used the proceeds of the Loan to make a capital contribution, as it in fact did. In the latter case, the purpose is to derive distributions in respect of the partner's investment in the partnership and not interest from an on-loan but, in both cases, the intervening step and not the eventual use by the partnership of the proceeds of the on-loan or the capital contribution must be the purpose for which the partner entered into its borrowing.

53. The second point relates to the legislation in Part 8 of the Income Tax Act 2007 (the "ITA") which provides for relief in certain circumstances for interest on loans to invest in partnerships and for loans to buy plant or machinery for partnership use. That legislation makes it clear that that relief is subject to a number of tightly-circumscribed conditions. For example, the relevant provisions preclude relief for overdraft interest (see Section 384(1) of the ITA) and for interest incurred in relation to loans forming part of tax avoidance arrangements (see Section 384A of the ITA). And the relief in relation to interest incurred on a borrowing to acquire plant and machinery for partnership use is confined to assets in respect of which the partnership is entitled to capital allowances or liable to a balancing charge (see Section 388(2) of the ITA) and to interest paid within three years after the end of the period of account in which the borrowing is made.

54. This leads me to ask myself why such stringent conditions and limitations would need to be imposed on the relief in Part 8 of the ITA if Mr McDonnell's submission is correct. For instance, if interest on a borrowing incurred by a partner for the purpose of financing any asset which is to be used in the partnership's trade qualifies automatically as a trading expense under the principle set out in *Vaines*, then why is the regime in Part 8 confined to interest on borrowings incurred to acquire only plant and machinery which is used in the partnership's trade (as opposed to any asset which is used in that trade) and why is the availability of that relief then further restricted by reference to plant and machinery qualifying for capital allowances and balancing charges within the partnership? Similarly, what is the point in the three-year time limit?

55. Turning (more relevantly in the case of these appeals) to the provisions in Part 8 of the ITA which relate to interest on borrowings incurred to make capital contributions to a partnership, why is relief denied to a limited partner in an English limited partnership (see Section 399(2)(a) of the ITA), why is relief denied if there has been a recovery of capital (see Section 399(3) of the ITA) and why is the deduction restricted to 40% of the interest paid if the partnership is a film partnership to which Section 400 of the ITA applies (see Section 399(4) of the ITA)?

56. The inescapable conclusion to be drawn from the existence of all of these restrictions is that no relief would be available for interest paid on the relevant borrowings in the absence of the regime in Part 8 of the ITA. And, in my view, this, in turn, means that Mr McDonnell's submission on this subject cannot possibly be right.

57. In the circumstances, I do not think that the mere fact that Section 387 of the ITA contains exclusions to prevent double reliefs is enough to gainsay the conclusion which I have reached. That provision should be regarded as a means of ensuring that relief is not accidentally given twice, whatever the reason for that might be.

58. Finally, I should mention the recent decision of the Court of Appeal in *Investec Asset Finance plc and another company v The Commissioners for Her Majesty's Revenue and Customs; The Commissioners for Her Majesty's Revenue and Customs v Investec Asset Finance plc and another company* [2020] EWCA Civ 579 ("*Investec*"). This case was mentioned by Mr Rivett in his submissions as being a recent case relating to the taxation of interests in partnerships but both parties submitted that, in view of the facts in that case, it had no relevance to my decision.

59. I agree with that assessment and therefore have not asked either party to make any submissions to me in relation to it. However, I will just say that, in the discussion in that case of what Lady Justice Rose described as "Issue 2: the Deductibility of Capital Contributions", it is apparent that it is an over-simplification to say that a capital contribution to a partnership is a step which can always be disregarded for UK tax purposes. In most cases, a capital contribution to a partnership which is transparent for UK tax purposes will be a "tax nothing" because of the transparency of the partnership. However, there will be circumstances – such as the situation for which the taxpayer in *Investec* was arguing – where a capital contribution can be a deductible trading expense for the partner which makes it. The only relevance of that in this particular case is that it serves to emphasise the conclusion which I have already reached in this decision - namely, that the purpose of the settlements to use the proceeds of the Loans to make capital contributions to the partnership cannot simply be elided out of existence and disregarded. It therefore tends to support, albeit somewhat obliquely, the conclusion which I have reached above.

60. For the reasons set above, I consider that Mr Rivett is right in saying that no deduction in computing a partner's share in a partnership's trading profits is available pursuant to the principle outlined by Lord Justice Henderson in *Vaines* for interest on a borrowing which is incurred by a partner for the purpose of financing a capital contribution which is to be made by that partner to the partnership, even if that capital contribution is being made solely so that that partnership can use the proceeds wholly and exclusively for the purposes of its trade.

Final observation

61. The conclusions which I have reached in relation to the two questions means that it is not necessary for me to address the further question which emerged at the hearing of whether the relief claimed by the Appellants should, if the claim were to be upheld, be given in respect of each of the three tax years to which the appeals relate, in accordance with the accrual of interest on the Loans, or instead only in respect of the tax year ended 5 April 2008, which is the tax year whose basis period was the one in respect of which all of the relevant interest was reflected in the accounts of the partnership – that is to say, in the Redwood 2008 Final Accounts. Mr McDonnell suggested at the hearing that the former was the correct approach on the basis that the interest had accrued over time notwithstanding that it had not been reflected in the Redwood 2006 Accounts or the Redwood 2007 Accounts but he candidly admitted that he did not know how much of the interest had actually accrued in each of the two earlier basis period and he did not produce any accounting evidence or legal authorities to explain why an expense which accrued in an earlier financial year but which was not reflected in the accounts for that financial year should nevertheless be deductible for tax purposes in the tax year for which that financial year was the basis period.

CONCLUSION

62. The above means that the appeals in this case fail, with the exception of the adjustments for work in progress in the tax year ended 5 April 2008 to which I referred at the outset of this decision. Those adjustments amount to a downward adjustment of £750,000 to the First Appellant's share of Redwood's trading profits and a downward adjustment of £750,001 to the Second Appellant's share of Redwood's trading profits, with, in each case, a corresponding reduction in the additional income tax and national insurance contributions which are due from the relevant Appellant, as set out in the relevant Closure Notice. Those adjustments have already been agreed by the Respondents and the Closure Notices in respect of the tax year ended 5 April 2008 should be amended to give effect to them.

63. The Closure Notices for each Appellant in respect of the tax years ended 5 April 2006 and 5 April 2007 are hereby confirmed.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

64. 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 Rules. 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.

TONY BEARE

TRIBUNAL JUDGE

RELEASE DATE: 17 JULY 2020