A golden contract

Large Corporate

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Keith Gordon looks at a case where HMRC tried to reinterpret the availability of enterprise zone allowances in relation to buildings constructed under a ‘golden contract’.

Key Points

What’s the issue?

Enterprise zones were designed to promote development in deprived areas through relaxed planning laws, relief from business rates, and tax reliefs to encourage private sector investment. However, since 2011, a large number of investments that had previously been made became subject to challenge.

What can I take away?

A claimant could incur construction expenditure under a contract that was entered into within the ten year life of the enterprise zone, provided that the expenditure is itself incurred within the following ten years, known as a golden contract. HMRC challenged such a contract in the case of *Cobalt Data Centre 2*.

What does it mean to me?

Should the current (or any future) government decide to introduce similar schemes with incentives embedded in the tax system, taxpayers will need extra reassurances or a lack of investor confidence could limit their take up.

The concept of enterprise zones (EZs) was born in the first year or so of Mrs Thatcher’s premiership. The idea was to generate development in deprived areas of the country by designating them as EZs where there would be relaxed planning laws and relief from business rates. There were also tax reliefs to encourage private sector investment. Broadly speaking, investors could claim up to 100% tax relief on the acquisition of new commercial buildings in an EZ, effectively a form of tax deferral as subsequent rental streams would be taxed in the normal way.

Without wishing to stray into party politics, I believe that the initiative is widely considered to have been a success. Indeed, whilst no new EZs were declared after 1997, a very similar initiative was introduced by the Labour party in the form of business premises renovation allowances (BPRAs).

Furthermore, focusing solely on the tax side, a working understanding of the rules seems to have been established between property developers and investors on the one hand and what was then Inland Revenue and is now HMRC on the other. This has been evidenced by the many properties that have been developed since the 1980s without significant murmur from the tax authorities.

The one major hiccup occurred in the early 1990s, when an £8m property was subject to a claim for allowances in relation to capital expenditure of £95m, the latter figure having been inflated by a combination of a lease at an unrealistic rent and a put option over the property in question. The Inland Revenue successfully challenged the case but that led to uncertainty in the market.

Given the political need for EZs to continue to attract investment, a modus operandi was subsequently agreed between the Inland Revenue and an organisation known as the Enterprise Zone Property Unit Trust Association, which was made up of persons who were at the time active in promoting investments in EZs. That agreement reassured investors that investments would continue to qualify for 100% relief, subject to a deduction reflecting the value of the underlying land (as required by the legislation). However, the Inland Revenue said that there should be a certificate from a surveyor confirming the property's value, which would include a reasonable rental figure. (In the case of pre-let properties, the certificate should confirm that the headline rent was reasonable.) The Inland Revenue also made it clear that it would challenge 'artificial arrangements aimed at securing allowances which would not otherwise be available'.

This modus operandi was honoured by the Inland Revenue and, later, by HMRC until 2011. Thereafter, there was a change of heart within HMRC and a large number of investments that had previously been made became subject to challenge. Even though those challenges started to emerge at the beginning of the decade, progress has been slow. An earlier indication of this change of policy can be identified from a closure notice application which was considered by the First-tier Tribunal in 2016 (Nichols & French v HMRC [2016] UKFTT 155 (TC)).

It is also widely understood that HMRC exerted further pressure on many EZ investors by the issue of accelerated payment notices (APNs) under the legislation enacted in the Finance Act 2014. Although one might think that APNs are relevant only in cases involving tax avoidance, many promoters of EZ arrangements made protective notifications to avoid even the risk of penalties and on the basis that they had nothing to hide. In a judicial review case concerning BPRAs issued to members of LLPs who had received partner payment notices, R (oao Carlton) v HMRC [2018] EWHC 130, the High Court considered that such arrangements were in fact notifiable. (See my article 'To DOTAS or not to DOTAS' in the July 2018 issue of Tax Adviser.) It should be noted that, subsequent to the Carlton decision, the taxpayers were largely successful in their LLP's later appeal against HMRC's closure notice, rendering the judicial review claim challenge to the partner payment notices (PPNs) in the main academic.

This article concerns the case of *Cobalt Data Centre 2 LLP and Cobalt Data Centre 3 LLP v HMRC* [2019] UKUT 342 (TCC).

The facts of the case

The taxpayer LLPs were incorporated as the investment vehicles for the development of two data centres which were constructed within what had been an EZ in Tyneside until 18 February 2006. Under the EZ legislation, it was not necessary for the construction expenditure to have been incurred during the ten year life of the EZ. As an alternative, it was possible for a claimant to incur expenditure under a contract that was entered into within the ten year period, provided that the expenditure is itself incurred within the following ten years (Capital Allowances Act 2001 s 298(1)). Such contracts are widely known as golden contracts.

The contracts in the present case were entered into on 17 February 2006 (i.e. just within the initial ten year period) between a property developer and a building contractor. These contracts were for the construction of buildings on two sites within the EZ. The taxpayer LLPs purchased the benefit of these contracts in early April 2011 (i.e. within the 2010/11 tax year). The specifications of the contracts were varied by agreement (so as to ensure that data centres would be constructed) and construction (to shell and core) was completed in December 2012.

The LLPs claimed that the expenditure incurred in April 2011 qualified for allowances under what was then the Capital Allowances Act 2001 s 296 on the following bases:

1. Expenditure had been incurred by a developer on the construction of the buildings. (The arrangements had been structured in such a way that the original developer had paid for the construction at the same time as it transferred the benefits of the contracts to the LLPs – the contractor was associated with the developer).
2. The interest in the buildings had been sold by the developer before each building’s first use (that being the purchases made by the LLPs in April 2011).

HMRC challenged the LLPs’ claims on the following bases:

1. It argued that the contracts entered into in 2006 had been varied so much by 2011 (at which time it was agreed that data centres would be constructed) that the actual construction was not in fact under the 2006 contract but under a new contract altogether, one necessarily having been made too late (i.e. more

than ten years after the site became part of an EZ).
2. HMRC argued that the LLPs were not carrying on business with a view to profit (so as to negate the rule that the LLPs' losses should be attributed to, and claimed by, its members.
3. Finally, HMRC argued that the amounts paid by the LLPs were not entirely for the purposes of the relevant interest in the buildings but were in part paid for something else.

In respect of the final issue, the LLPs claimed that HMRC's refusal contradicted the widely accepted modus operandi that had been in place since 1994 and therefore amounted to a breach of the LLPs' legitimate expectation (a topic which I wrote about in the December 2019 issue of Tax Adviser 'Stuck in second gear').

There was a change of heart within HMRC and a large number of investments that had been made became subject to challenge.

Because of this public law challenge, the LLPs commenced judicial review proceedings, as well as notifying their appeal to the First-tier Tribunal. The parties agreed that it would make sense for all strands of the challenge to be heard at a single combined hearing. Accordingly, following a rarely used (and indeed rarely appropriate) procedure, the appeals were transferred from the First-tier Tribunal to the Upper Tribunal and (applying a rather more common procedure) the judicial review claims were transferred to the Upper Tribunal.

The tribunal's decision

The case came before Mr Justice Zacaroli and Judge Jonathan Richards. They broadly allowed the appeals and the corresponding judicial review claims.

In particular, the Upper Tribunal concluded that the amendments made to the golden contracts were no more than that. In particular, they did not cause the golden contracts to be rescinded and replaced by a new set of contractual obligations. Allied to this, the Upper Tribunal concluded that the golden contracts, although drafted in fairly generic terms, were nevertheless contracts for the construction of buildings and were not merely agreements to agree something at a later date.

In respect of HMRC's second argument, the Upper Tribunal recognised that the LLPs themselves were primarily set up in order to facilitate the claims to EZ allowances by their members. Nevertheless, on the strength of the detailed evidence before the tribunal (which made clear that, although there was no negotiation about the prices to be paid to the developer for the interest in the properties, there had been hard negotiations on the overall package), the tribunal accepted that they had a subsidiary purpose of carrying on a business with a view to profit. Accordingly, the LLPs could be treated as tax transparent, so that their members would be entitled to a share of the LLPs' losses.

HMRC must ensure that reliefs claimed are no more than the law permits. However, its conduct hardly promotes trust.

On the third line of challenge, the tribunal sided with HMRC in recognising that the legislation contained more than one (albeit potentially overlapping) restriction on the amount of qualifying expenditure.

After considering the issues, the tribunal concluded that in particular: zzs 296 required expenditure to be 'for' the interest in the building (and so would exclude extraneous expenditure within any sum paid);

- s356 also required expenditure to be apportioned, for example where a building comprised both qualifying and non-qualifying parts (such as a dwelling); and
- s357 addresses a different matter, being where the amount of the expenditure has been artificially enhanced so as to increase the amount potentially claimable by way of allowances.

Despite these conclusions, the tribunal upheld the majority of the LLPs' claims. In particular, it found that rental support arrangements, which effectively guaranteed a certain level of rental income and which were included in the rights acquired by the LLPs, were an inherent part of the interest in the respective buildings. Accordingly, although separately itemised, the LLPs were entitled to treat the costs as qualifying expenditure. Conversely, the rights in respect of support for expenses incurred were held to be extraneous to the interests in the buildings. Accordingly, their costs were to be held not to be qualifying expenditure. A similar conclusion was reached in relation to the costs for assistance to the LLPs in repaying the loans which enabled them to acquire the buildings ('capital repayment support arrangements') and the right to receive the funds which would enable the LLPs to pay an arranger's fee.

When addressing the judicial review challenge, the tribunal noted that the long-established practice endorsed by the Inland Revenue (and continued by HMRC until

2011) provided that rental support arrangements would be treated as an inherent part of the property acquired.

Therefore, irrespective of the strict interpretation of the legislation, the LLPs would have been entitled to treat the costs of these arrangements as qualifying expenditure. Furthermore, it was held that the same practice extended to expense support arrangements so that the LLPs were entitled to claim EZ allowances in respect of those costs, despite the tribunal’s conclusion on the correct legal position. However, the LLPs could not establish a legitimate expectation in relation to the capital repayment support arrangements or the arranger’s fees.

Commentary

There is something rather unsavoury about HMRC resiling from a previously stated position without warning and it is reassuring that the Upper Tribunal has held HMRC to the position that it had considered acceptable for almost two decades. However, in my view, there is still something particularly unedifying about HMRC’s actions in these cases. Taxpayers were expressly encouraged to invest their money into buildings in deprived areas, such encouragement being through the tax system. Indeed, in many cases, it was only the promise of the tax relief that made the investments viable.

The buildings were undoubtedly developed, and the political aims were achieved. Yet, a few years later, HMRC (which, after all, is an arm of government) came along with a view to withdrawing the tax relief previously claimed. Of course, HMRC must ensure that reliefs claimed are no more than the law permits. However, its conduct as demonstrated in the present case and in Carlton hardly promotes trust between taxpayer and the government. Should the current (or any future) government decide to introduce similar schemes with incentives embedded in the tax system, taxpayers will need extra reassurances that HMRC will not routinely lurk around the corner, seeking to recover the tax reliefs claimed. Otherwise, a lack of investor confidence could impact on the take up of such schemes and render the initiative a political failure.

What to do next

Given the amounts at stake in this case alone (as well as in other similar cases), it is probably inevitable that the case will be proceed to the Court of Appeal. However, it is fair to say that the decision vindicates the approach taken by promoters of EZ developments. Furthermore, where taxpayers have been forced to make payments to HMRC through the issue of APNs (or PPNs), based upon HMRC’s now discredited challenges to claims for EZ allowances, taxpayers might now consider asking for a large slice of their money back.