Enterprise zone allowances: the basis of a ‘golden contract’

Large Corporate Property Tax

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We revisit a case which looks at the viability of enterprise zone allowance claims on the basis of a ‘golden contract’.

Key Points

What is the issue?

Enterprise zone allowances were ordinarily available in respect of expenditure incurred within ten years of the site being included in the zone. However, under in the Capital Allowances Act 2001 s 298, ‘golden contracts’ effectively doubled the period in which the favourable capital allowance regime was available in enterprise zones.

What does it mean for me?

The decision in this case looks as if it fully vindicates HMRC’s views that there is only so far that one can stretch a golden contract.

What can I take away?

The question of whether the golden contract has been rescinded is not always that relevant: what matters is whether or not the revised contractual terms form part of that contract or whether they are the result of a fresh agreement.

In my article ‘A golden contract’ in the February 2020 issue of *Tax Adviser*, I discussed the Upper Tribunal’s decision in favour of the taxpayer in the case of *Cobalt Data Centre 2 LLP and Cobalt Data Centre 3 LLP v HMRC*. HMRC appealed against the decision and the case has now been heard by the Court of Appeal ([2022] EWCA Civ 1422).

The facts of the case

At the heart of the case is a provision in the Capital Allowances Act 2001 s 298, which concerns expenditure on the construction of a building situated within an enterprise zone.

Enhanced capital allowances (enterprise zone allowances) were ordinarily available in respect of expenditure incurred within ten years of the site being included in the zone. However, s 298 provided a slight relaxation of this rule. Provided that the expenditure was incurred under a contract entered into within that ten year period (colloquially referred to as a ‘golden contract’), qualifying expenditure could actually be incurred any time within 20 years of the site first being included within the relevant enterprise zone. In other words, these golden contracts effectively doubled the period in which the favourable capital allowance regime was available in enterprise zones.

The case concerns a site which, since February 1996, was located within the Tyne Riverside Enterprise Zone. Just a day before the ten year period was due to expire (i.e. in February 2006), a contract was entered into between a developer and a contractor in respect of the site. Rather than specify a single development project, the contract proposed various options in relation to three different areas on the site.

Subsequently, in accordance with a clause of the 2006 contract, the entered parties varied the nature of the work to be undertaken on the site. Furthermore, in 2011, it was agreed that the construction should now be of a data centre for £54 million plus VAT instead of what had been previously agreed, being the construction of a semiconductor manufacturing facility.

Shortly after this change, Cobalt Data Centre 2 LLP (Cobalt) acquired an interest in the project for £153 million. HMRC argued that Cobalt’s expenditure did not qualify under s 298.

The Court of Appeal’s decision

The case came before Lord Justice Lewison, Lord Justice Newey and Lady Justice Andrews. All three gave judgments, although the main judgment was given by Lewison LJ. Although all judges reached the same conclusion, the reasoning differed slightly, with Newey LJ being in a minority.

Lewison LJ disagreed with the first limb of HMRC’s case. HMRC had tried to suggest that to qualify for allowances under s 298, expenditure had to have been something that the payer was unconditionally obliged to pay under the original ten year period. (This would mean that the golden contract must commit the payer to incur the expenditure, even if the actual incidence of the expenditure would arise outside the ten year period.)

The judge felt that this was to put in restrictions that were not found in the legislation itself. Therefore, as argued for by Cobalt, it was sufficient to show that the expenditure was incurred under the golden contract within the extended ten year period: the golden contract itself did not have to make that expenditure inevitable.

However, as the judge made clear, the actual expenditure had to be under the original contract. For example, it would not be appropriate for a golden contract to lead to one building being constructed (within the normal ten year period) and then that contract purportedly varied at a later date so as to lead to the construction of a second building. That purported variation, the judge said, would in fact amount to a fresh contract (and, if made outside the normal ten year period, would not attract enterprise zone allowances).

Furthermore, the judge considered the relevance of the parties' subjective intentions; i.e. whether their revised agreement should be treated as a variation of the original contract or a wholly new agreement. Agreeing with the Upper Tribunal, he held that those subjective intentions were relevant to the nature of any varied agreement. However, disagreeing with the Upper Tribunal, he held that they were not determinative: instead, they would be relevant only in borderline cases. It is for a court to decide the categorisation of the parties' revised agreement. (In those few cases, such as the present, where it actually matters, it is ordinarily of little consequence for the parties themselves as they would usually be more concerned with their respective rights and obligations under the revised agreement and not the legal classification of the change.)

As to how this applies in any particular case will ultimately depend on the precise circumstances and whether the revised terms can be reconciled with the previous agreement between the parties. Referring to the facts of the present case, the judge remarked that 'a contract to construct a materially different building on a wholly different site and at a substantially different price … results in a new contract rather than a variation'. That is what happened in this case and therefore Lewison LJ allowed HMRC's appeal.

Lord Justice Newey reached a similar result but by a marginally different route. Of particular interest was his conclusion that a desire to fall within (or outside) a particular tax treatment can be a relevant determination when ascertaining the parties' subjective intentions. However, on the facts of the case, the tax position was considered not to be sufficiently significant to justify a conclusion that the revised agreement was merely a variation of the original contract.

Lady Justice Andrews said that she agreed with Lewison LJ. However, in a short concurring judgment of her own, she summarised the essence of the court's decision in the present case:

> 'Since the developer was requiring the contractor to carry out building work which was wholly outside the existing scope of the golden contract, for a consideration not mentioned in that contract, and on a part of the site not covered by the works option which it had already exercised, then if the contractor agreed to do the work for that price, in my judgment the correct analysis is that they made a fresh contractual bargain.'

For these reasons, HMRC’s appeal was allowed.

Commentary

This decision therefore looks as if it fully vindicates HMRC’s views that there is only so far that one can stretch a so-called golden contract. However, HMRC’s victory is likely to be Pyrrhic. As I explained in my earlier article, specialists who had been working in the world of enterprise zones and their HMRC (previously, Inland Revenue) counterparts had long had a joint understanding that would permit enterprise zone allowances to be claimed in such circumstances. It was only a change of HMRC’s approach in around 2011 that put the previous practice in doubt. However, HMRC then sought to apply its new (and now vindicated) interpretation to prior expenditure.

As I said in 2020, there is something unedifying about governments encouraging expenditure to be incurred (a disadvantaged area gets the desired investment and the investor gets tax relief) only for the tax relief to be withdrawn retrospectively. Quite sensibly, the taxpayers in the present case launched judicial review proceedings in order to preserve the benefit of the previous HMRC position (irrespective of its correctness in law).

At the previous hearing, the Upper Tribunal allowed the judicial review claim and that decision was not subject to further appeal. As a result, it looks as if the Court of Appeal’s decision will be of benefit to HMRC only in respect of those cases where a judicial review was not commenced or to those cases (if any) where expenditure was incurred after HMRC’s change of position became known.

One of the interesting features of this case is the fundamental difference between the approach of the Upper Tribunal and that of the Court of Appeal and, in a similar vein, between the respective approaches of the parties. Accordingly, a lot of the arguments had focused on the question as to whether the golden contract had been rescinded (i.e. on the assumption that the revised terms were so different from those previously agreed) so that the revised agreement represented a new contract altogether.

However, the Court of Appeal has shown that matters are a little more nuanced than that. As the court made clear, the question of whether the golden contract has been rescinded is not always that relevant: what matters is whether or not the revised contractual terms form part of that contract or whether they are the result of a fresh agreement. Even in the latter scenario, the original contract might continue in effect.

What to do next

Advisers with similar enterprise zone allowance cases will, of course, realise that the Court of Appeal’s decision means that the allowances are not strictly available. However, they should first ascertain whether their clients are protected by judicial review proceedings.

The court’s decision will also be relevant if new legislation is ever introduced to replicate the enterprise zone rules. However, at the time of writing (shortly before the 17 November Autumn Statement), the fate of the proposed investment zones lies somewhat in the balance.