The Centrica case: are management expenses tax-deductible?

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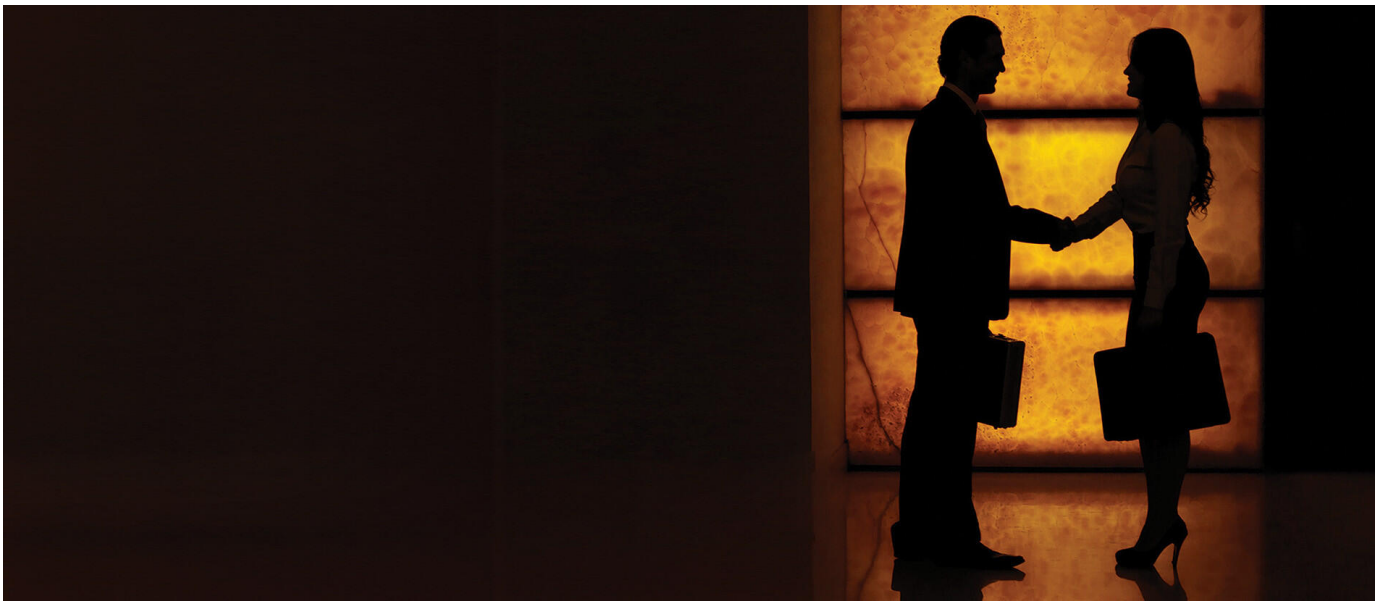

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Management expenses incurred before a firm decision is taken to proceed with a particular transaction may be capital in nature, and therefore not tax-deductible.

Key Points

What is the issue?

The important Supreme Court decision in *Centrica Overseas Holdings Limited v HMRC* addresses the deductibility of expenses incurred by a company with investment business in connection with the proposed disposal of an investment.

What does it mean for me?

The decision puts beyond doubt that such expenses may be non-deductible by virtue of being capital in nature, even where they fall to be regarded under pre-existing

case law as expenses of management. Whilst the case considered costs of disposal, the same principles apply in the context of an acquisition.

What can I take away?

Until recently, it was generally thought that transaction-related expenses should, if incurred before a firm decision is taken to proceed with a specific transaction on specific terms, usually be deductible expenses of management. The Supreme Court has now confirmed that a more nuanced approach is required, to establish whether the expenditure is capital or revenue in nature, using the same principles that apply to trading businesses.

A 2022 decision of the Court of Appeal put companies with investment business, including ultimate and intermediate holding companies in trading groups, on notice that a legislative amendment in 2004 may have had consequences that were not previously widely recognised.

Unanimously confirming that decision in *Centrica Overseas Holdings Limited v HMRC* [2024] UKSC 25, the Supreme Court has made clear that expenses incurred by such companies should be analysed to determine whether they are capital or revenue in nature, applying the same principles that would be applied to expenses incurred by a trading company. Any costs that belong in the capital bucket are not deductible as expenses of management – and in cases where the substantial shareholding exemption applies or is expected to apply to the disposal of the underlying asset, this will generally mean that no tax relief is available at all.

Factual background

Centrica Overseas Holdings Limited, an intermediate holding company in the Centrica plc group, held an investment in an overseas sub-group, Oxxio. A strategic decision to sell the Oxxio business was taken in the summer of 2009, but a transaction with a specific buyer (Eneco) was not approved by the company's board until 22 February 2011. That transaction completed in March 2011.

Various expenditure was incurred in connection with the disposal, including:

- corporate finance fees payable to Deutsche Bank for services in relation to the disposal of Oxxio, including identifying and evaluating potential purchasers, managing the disposal process and providing advice in relation to potential transaction structures (e.g. share or asset sale);
- vendor due diligence fees payable to PwC; and
- legal fees payable to De Brauw, a Dutch law firm, for legal advice on the sale, covering the employment, competition, tax and contract law implications, as well as drafting a sale and purchase agreement and preparing a virtual data room.

Centrica Overseas Holdings Limited sought a deduction for the above expenditure, referred to in the litigation as the 'Disputed Expenditure', on a time apportioned basis. In its tax return, it recognised deductible expenses of management for a proportion of the Disputed Expenditure calculated as:

- the number of days between the parties being engaged and the 22 February 2011 decision to sell to Eneco; divided by
- the total number of days between the parties being engaged and the transaction completing.

No deduction was sought for the element deemed to accrue between the date the board decided to proceed with the Eneco transaction and the date the transaction completed. This treatment was consistent with Centrica's understanding of the relevant provisions of the Corporation Tax Act (CTA) 2009, based on the precedent case law at the time.

Legal background

Prior to the *Centrica* case, the key authorities considering the deductibility of expenses incurred by a company with investment business were *Sun Life Assurance Society v Davidson (Inspector of Taxes)* [1958] AC 184 (*Sun Life*) and *Atkinson (Inspector of Taxes) v Camas plc* [2004] EWCA Civ 541 (*Camas*).

Sun Life concerned brokerage fees and stamp duty incurred on the purchase of certain investments, and established that the cost of acquiring an investment (including any costs that cannot be severed from such an acquisition) is not an expense of management.

Camas concerned the application of this principle in the context of an aborted transaction – the taxpayer incurred financial, legal and other advisory costs in drawing up a bid, which it sought to deduct as expenses of management. The Court of Appeal found that this treatment was consistent with the decision in *Sun Life*, as the expenditure was incurred for the purpose of assessing whether or not to make an acquisition, and thus an expense of management rather than a cost of acquisition. It was also satisfied that there was, at the time, nothing in the legislation governing the tax treatment of expenses of management that prevented deductions being obtained for expenditure of a capital in nature.

In its commentary on changing investments in the management expenses section of its Company Taxation Manual (CTM08190), HMRC provides the following commentary on the application of *Sun Life* and *Camas*:

> ‘Expenditure preparatory to making a decision to purchase will generally be an expense of management. Once the decision to acquire has been made then the expenditure is likely to fall into the category of “costs of implementation of a purchase already decided upon” and will therefore not be an expense of management.
>
> ‘The decision to acquire/purchase would normally be evidenced at the latest by, for example, an offer being made to the target company, when the expenditure ceases to be on decision making and becomes part of the implementation of a purchase already decided upon. Up to that point the expenses are generally all on decision-making and are not sufficiently direct costs of the acquisition…
>
> ‘The principles established apply equally to acquisitions and disposals and to abortive as well as to successful expenditure.’

Understandably, Centrica considered that it was following the principles established in the earlier cases and reflected in this guidance when it adopted the time apportionment approach described above. However, a new provision was introduced into the relevant legislation in response to the *Camas* litigation, which of course could not be considered in that case. That now forms limb (a) of CTA 2009 s 1219(3), which provides that, subject to a few specific exceptions outlined in s 1221(1) of the same act, no deduction is allowed as an expense of management for ‘items of a

capital nature’. The interpretation of this provision would ultimately determine the outcome of the *Centrica* case.

The issue before the Supreme Court

Centrica’s appeal was initially dismissed by the First-tier Tribunal, essentially on the basis that it was not persuaded that Centrica Overseas Holdings Limited actually carried out any investment management activities in relation to which it could have incurred the Disputed Expenditure.

However, in case (as ultimately transpired) it was wrong in that conclusion, the First-tier Tribunal also stated that it considered that the Disputed Expenditure consisted of expenses of management in line with the principles established in *Sun Life* and *Camas*, and those expenses were not capital in nature.

The Upper Tribunal overruled the decision that Centrica Overseas Holdings Limited did not carry out the relevant investment management activities, but broadly agreed with the First-tier Tribunal that the Disputed Expenditure represented expenses of management and was not capital. The conclusion on the capital expenditure issue was, in essence, reached because the expenses could not be said to be ‘one-off’ costs (as Centrica Overseas Holdings Limited had many other capital investments), and because at the time that the expenses were incurred it could not be guaranteed that Oxxio would be sold.

Arguing that the tribunals were wrong on both the expenses of management and capital expenditure issues, HMRC appealed to to the Court of Appeal, which dismissed the arguments on the former ground but, in a dramatic turnaround, agreed that the Disputed Expenditure was capital in nature.

Noting that the earlier cases were decided before the prohibition on capital expenditure now provided by CTA 2009 s 1219(3)(a) was introduced, the Court of Appeal considered that the First-tier Tribunal and Upper Tribunal had confused the tests for determining whether expenditure is an expense of management with the test for determining whether it is made on capital or revenue account.

It accepted HMRC’s argument that money which is expended in order to achieve the acquisition or disposal of a capital asset is also capital in nature and considered that the Disputed Expenditure answered to this description.

The sole issue before the Supreme Court was, therefore, whether the Court of Appeal was correct to decide that the Disputed Expenditure was capital in nature. Counsel for Centrica advanced two arguments as to why this was wrong: firstly contending that the principles that apply when determining whether expenses of management are capital in nature are different to those that apply when making this assessment in respect of expenditure of a trading company; and secondly that the Disputed Expenditure was revenue in nature even if the first ground failed.

The meaning of ‘capital’

Dismissing Centrica’s first ground of appeal, the Supreme Court determined that the reference to ‘items of a capital nature’ in CTA 2009 s 1219(3)(a) had the same meaning as the phrase ‘expenses of a capital nature’ in CTA 2009 s 53(1), which is the relevant provision in the rules governing the calculation of trading profits. Both of these provisions ‘plainly intended to carve out those expenses which are capital in nature by reference to the well established principles developed by the courts on that distinct legal question.’

Counsel for Centrica had sought to persuade the Supreme Court that the meaning of ‘capital’ must be different for companies with investment business, because all investments are capital, so all expenditure incurred by such a company must be concerned with capital assets. Thus, it was argued, the rules allowing deductions for expenses of management would be largely redundant if HMRC and the Court of Appeal’s position were adopted.

This submission was flatly rejected, on the basis that day-to-day costs of managing investments that a company with investment business may typically incur (such as staff costs, rent and administration costs, and repairs) would be considered revenue expenditure, rather than capital, under the established principles.

There is therefore ample scope for deductions to be obtained under the expenses of management code without having to depart from those principles.

Was the Disputed Expenditure capital in nature?

The question as to whether expenditure is capital or revenue in nature is a question of law, and hence the Supreme Court was satisfied that it and the Court of Appeal were entitled to come to their own conclusions based on the findings of fact made by the First-tier Tribunal.

Summarising the precedent case law, the Supreme Court stated that the objective purpose for which a payment is made is an important indicator of its nature, and that money spent on the acquisition or disposal of an identifiable capital asset should, as a starting point, be assumed to be capital in nature. That assumption may be rebutted in some circumstances – the example given being the case of *Lawson (Inspector of Taxes) v Johnson Matthey plc* [1992] 2 AC 324.

Consequently, the character of the Disputed Expenditure fell to be determined by reference to the transaction for which it was incurred. The Supreme Court considered it clear that, 'once a commercial decision was taken to dispose of the Oxxio business, the services of Deutsche Bank, PwC and De Brauw were obtained precisely to enable management to achieve that disposal'. As the Disputed Expenditure was incurred to bring about the disposal of an identifiable capital asset, it was indeed capital in nature.

Where are we now?

Following *Camas*, the prevailing practice for companies with investment business placed significant emphasis on the time at which expenditure was incurred to determine whether expenditure was deductible as an expense of management. It was widely thought that would also determine whether the expenditure was capital in nature. Indeed, even HMRC's guidance at CTM08260 places significant emphasis on the importance of the timing of a firm decision to buy or sell when determining whether expenditure is capital.

The Supreme Court, however, took a different approach. It emphasised the importance of identifying the purpose of the expenditure based on the transaction for which it was incurred.

> 'Money expended to achieve a disposal of a capital asset is properly regarded as being of a capital nature. The nature of Centrica Overseas Holdings Limited's business does not affect that conclusion. If a trading

> company disposes of a capital asset, the costs of bringing about that disposal (such as the fees of professionals involved in the sales process) will also be capital in nature. The same should be true of an investment company.' [para 87]

It does not matter that there may be uncertainty as to whether a proposed transaction will proceed to a successful conclusion – as the Supreme Court noted, 'expenditure on an abortive capital disposal transaction is capital expenditure nonetheless'. Centrica would have succeeded in its appeal if the legislation had not changed following *Camas*. It seems, therefore, that CTA 2009 s 1219(3)(a) has more significance than was perhaps appreciated at the time it was introduced. This judgment, which becomes the most important authority on transaction-related expenses incurred by investment holding companies, demonstrates that the bar for obtaining deductions has been raised considerably.