[2018] UKFTT 0597 (TC)

TC06759

Appeal number: TC/2010/09293
TC/2010/00411
TC/2017/00914
TC/2018/00262

PROCEDURE – Tribunal releasing "decision in principle" in relation to 2006-07 tax year –construction of closure notice – whether appellants can now make arguments on status of licence fee income in 2006-7 – whether Tribunal has jurisdiction to hear such arguments – yes – application allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

THE VACCINE RESEARCH LIMITED PARTNERSHIP **Appellants**
PATRICK LIONEL VAUGHAN

- and -

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

TRIBUNAL: JUDGE JONATHAN RICHARDS

Sitting in public at Taylor House, Rosebery Avenue, London on 17 September 2018

David Southern QC, instructed by Bryan Cave Leighton Paisner LLP for the Appellant

David Yates, instructed by the General Counsel and Solicitor to HM Revenue & Customs, for the Respondents

DECISION

1. In 2012 the First-tier Tribunal ("FTT") issued a "decision in principle" in the appellants' income tax appeals dealing with the 2006-07 tax year and invited the parties to agree matters to give effect to the decision in principle. In 2014, the FTT's decision went on appeal to the Upper Tribunal following which that decision was undisturbed. The parties have not been able to agree matters in relation to the 2006-07 tax year and therefore it is agreed a further hearing before the FTT will be necessary to determine some outstanding issues for 2006-07. The appellants have also made further appeals in respect of the 2013-14 and 2014-15 tax years. In very broad summary, this decision is concerned with the extent to which the appellants can make arguments either in relation to the 2006-07 years or other years under appeal, that they did not raise, and neither the FTT nor the Upper Tribunal fully resolved, in the "decision in principle" dealing with the 2006-07 tax year.

Relevant background

2. The first appellant, the Vaccine Research Limited Partnership (the "Partnership") is a limited partnership established under Jersey law. It is common ground that it is a partnership for UK tax purposes. The second appellant, Mr Vaughan, is a partner in the Partnership.

3. Both Mr Vaughan and the Partnership have been engaged in a long-running dispute with HMRC. The Partnership claimed that it made a loss for income tax purposes (largely because it was entitled to capital allowances for expenditure incurred on research and development). Mr Vaughan sought to set his share of the Partnership's loss "sideways" against other income. HMRC, however, did not agree that the Partnership had made any loss. They also disputed other aspects of the tax treatment that the Partnership and Mr Vaughan were claiming.

4. On 16 November 2009, HMRC issued a closure notice to the Partnership setting out the conclusions of HMRC's enquiry into the Partnership's tax return for 2006-07 under s28B of the Taxes Management Act 1970.

5. On 24 June 2010, HMRC reflected the above decision by amending Mr Vaughan's return for the 2006-07 tax year (denying him relief for the share of the Partnership loss that he had claimed). HMRC also made a formal decision that Mr Vaughan was not entitled to tax relief for interest he incurred on borrowings taken out to fund his investment in the Partnership.

6. The Partnership and Mr Vaughan both appealed to the Tribunal. The FTT addressed the following issues in its decision released on 27 December 2012 (the "FTT Decision")[1]:

[1] The extent to which the FTT was entitled to, or did, make findings on other issues was disputed and we address that issue below.

Issues relevant to the Partnership's appeal

(1) The "trading issue" namely whether the Partnership was carrying on a trade in the 2006-07 tax year. The FTT concluded that the Partnership was carrying on a trade (see paragraph [72] to [76] of the FTT Decision) which meant that it satisfied a basic condition relevant to its entitlement to capital allowances. However, as will be seen, the FTT did not consider that all of the Partnership's activities were "trading" in nature.

(2) The "quantum issue", namely how much expenditure the Partnership incurred "on" research and development under s437 of the Capital Allowances Act 2001 ("CAA 2001"). The FTT concluded that only £14m (out of a total of £186m claimed) was eligible for capital allowances (see paragraph [68] and [92] of the FTT Decision.

(3) The "fee deductibility issue", namely whether a fee of some £7m that the Partnership paid was deductible for tax purposes. The FTT concluded that the fee was not deductible (see [85] to [89] of the FTT Decision).

Issues relevant to Mr Vaughan's appeal

(4) The "commercial basis issue", namely whether Mr Vaughan was trading on a commercial basis with a view to a profit (the condition he needed to meet in order to set his share of any Partnership losses "sideways" against other income). The FTT concluded that he was (see [82] of the FTT Decision).

(5) The "trade location issue", namely whether Mr Vaughan was carrying on the relevant trade in the United Kingdom (which was also relevant to his ability to set his share of losses off against other taxable income). The FTT concluded that he was doing so (see [84] of the FTT Decision)

(6) The "interest relief issue", namely whether Mr Vaughan was entitled to relief for interest on loans that he took out in order to finance his acquisition in the Partnership. The FTT concluded (see [91] of the FTT Decision) that Mr Vaughan was entitled to relief only for part of that interest.

7. There was then an appeal by the Partnership and Mr Vaughan, and a cross-appeal by HMRC, to the Upper Tribunal. In its decision of 2 September 2014 (the "Upper Tribunal Decision"), the Upper Tribunal determined the issues as follows although, as with the FTT Decision, Mr Southern submitted that other issues had been determined as well:

(1) The Upper Tribunal declined to interfere with the FTT's conclusions on the trading issue (see [58] of the Upper Tribunal Decision), the quantum issue (see [85] of the Upper Tribunal Decision) and the fee deductibility issue (see [126] of the Upper Tribunal Decision).

(2) The Upper Tribunal also declined to interfere with the FTT's conclusions on the commercial basis issue (see [97] of the Upper Tribunal Decision) and the interest relief issue (see [116] of the Upper Tribunal Decision).

(3) On the trade location issue, the Upper Tribunal concluded that the FTT applied the wrong test. However, the FTT's overall conclusion was correct and therefore the Upper Tribunal declined to interfere with the FTT's decision on the trade location issue.

8. The appeals of Mr Vaughan and of the Partnership referred to at [6] and [7] above (which I will refer to as the "earlier appeals") were concerned only with the tax treatment of the Partnership and of Mr Vaughan in the 2006-07 tax year. Following the Upper Tribunal's determination of the earlier appeals, the Partnership and Mr Vaughan made further appeals to the FTT (which I will refer to as the "later appeals") as follows:

(1) Mr Vaughan has sought to appeal against a closure notice that HMRC issued him (and not the Partnership) in relation to the 2006-07 tax year. That closure notice expressed the conclusion that Mr Vaughan's share of the Partnership's loss for that period was not £14,664,689 (as Mr Vaughan had claimed) but was £1,157,853.

(2) The Partnership has brought further appeals against partnership closure notices that HMRC issued for the 2013-14 and 2014-15 tax years. In those appeals, the Partnership is arguing that licence fees that it is receiving are not taxable income.

Underpinning both of these appeals are contentions, by the Partnership and Mr Vaughan that, while the Partnership now accepts, following the decisions of the FTT and Upper Tribunal, that it is not entitled to all the capital allowances it originally claimed, it is entitled to some capital allowances. Moreover, it argues licence fees it received are not taxable income. Therefore, the appellants argue, the amount of capital allowances that needs to be set off against the Partnership's taxable income is lower than HMRC have calculated with the result that the loss of the Partnership, and so Mr Vaughan's share of that loss, are both higher than HMRC have calculated.

The applications at issue

9. Mr Vaughan and the Partnership are asking for the following directions from the FTT:

(1) A direction that the two later appeals be joined and heard together by the same judge. HMRC agree that this direction is appropriate (although they reserve the right to argue that Mr Vaughan's later appeal referred to at [8(1)] is an abuse of process and should be struck out).

(2) A direction that the two earlier appeals be "relisted" (without any need for a notice of appeal to be filed) with those two earlier appeals being heard together with the two later appeals. The term "relisted" is seeking to encapsulate the general concept that the FTT should still be regarded as having conduct of the earlier appeals on matters which were not determined in the earlier decisions (particularly the question of whether the licence fees are taxable income or not).

(3) A direction that findings of fact in the two earlier appeals may be taken as established in the later appeals without the need for further evidence or proof.

10. Mr Southern, who appeared for Mr Vaughan and the Partnership, justified these proposed directions on the following grounds:

(1) Given the principles set out in, among others, *Caffoor (Trustees of Abdul Caffoor Trust) v Income Tax Commissioner* [1961] AC 584 and *King v Walden* [2001] STC 822 there could be no sensible objection to the Partnership making any point as to the taxability or otherwise of licence fees in the 2013-14 and 2014-15 tax years. Even if those arguments were inconsistent with the Tribunal's conclusions in 2006-07 (which they were not), income tax is assessed annually and determinations for one period of assessment could not be binding in later periods of assessment.

(2) Therefore, the Partnership is entitled as of right to argue that licence fees are not taxable in 2013-14 and 2014-15. It follows that only the application to reopen this issue for 2006-07 can possibly be contentious. In that regard, the FTT Decision was a decision in principle only. There was no formal determination of the amount of the Partnership's taxable income for 2006-07, only of specific issues relating to its entitlement in that tax year to a deduction for capital allowances and other expenses. Therefore, in relisting the appeals, the Partnership and Mr Vaughan are not seeking to reopen an issue that has been finally determined for 2006-07: they are asking the FTT to determine an issue that remains undetermined.

(3) The decisions of the FTT and Upper Tribunal (that the Partnership was not entitled to all capital allowances claimed in 2006-07) went hand in glove with a conclusion that the licence fees received were not trading income of the Partnership in that tax year. It would be unfair if the Partnership and Mr Vaughan were fixed with the adverse consequences of the Tribunals' conclusions (that full capital allowances are not available) without benefiting from the benign aspect of those conclusions (which opens the door to an argument that licence fees were not taxable income).

(4) The Tribunal has a case management discretion to grant the directions sought. In all the circumstances, the directions proposed are fair and proportionate and would achieve the desirable result that the Tribunal does not have to make separate findings of fact all over again in the later appeals.

11. Mr Yates, who appeared for HMRC contested some (but not all) of the applications and outlined HMRC's position which was as follows:

(1) HMRC agree with the analysis set out at [11(1)]. The Partnership and Mr Vaughan are free to argue that the licence fees that the Partnership received in 2013-14 and 2014-15 were not taxable income.

(2) HMRC agree that findings of fact made in the FTT's hearing of the earlier appeals should be taken as established in the later appeals. However, no "relisting" of the earlier appeals is needed to do this: a simple direction (to which HMRC would consent) would suffice.

(3) HMRC agree that Mr Vaughan's earlier appeal has not been fully disposed of in a minor respect. The FTT, with whom the Upper Tribunal agreed, decided

that Mr Vaughan was entitled to a deduction for a proportion of the interest he incurred to finance his investment in the Partnership. The FTT set out a method for the calculation of the proportion but did not make a final determination of the figures. Therefore, to the extent that the parties cannot agree on the effect of the Tribunals' decision as regards Mr Vaughan's entitlement to interest relief, the FTT retains jurisdiction to decide that issue.

(4) The Partnership's earlier appeal has been disposed of. That was an appeal against a partnership closure notice none of whose conclusions related to the level of taxable income of the Partnership. At no point during HMRC's enquiry, correspondence or in arguments before the FTT was there any suggestion that the licence fees were not taxable income. This is not, therefore, an unanswered question. The FTT either does not have jurisdiction to hear any further argument on the status of licence fees that the Partnership received in 2006-07 or, given the passage of time and the way that the Partnership and Mr Vaughan made their cases before both the FTT and the Upper Tribunal, the FTT should decline to exercise its discretion to hear such arguments.

Discussion

12. The only real point of contention between the parties is whether the FTT can, or should, permit the Partnership and Mr Vaughan to advance arguments to the effect that licence fees were not taxable income of the Partnership in 2006-07. Central to the determination of that issue is the question of what issues were properly before the FTT and Upper Tribunal in 2012 and 2014 respectively.

The issues that were before the FTT and Upper Tribunal in 2012 and 2014

13. The Partnership was appealing against a closure notice under s28B of the Taxes Management Act 1970. It is now well established, following the Supreme Court's decision in *Tower MCashback v HMRC* [2011] UKSC 19 and the Court of Appeal's decision in *Fidex Ltd v HMRC* [2016] EWCA Civ 397 that the Partnership's appeal was against the conclusions set out in that closure notice. In *Fidex*, Kitchin LJ explained the principle as follows:

> 45.In my judgment the principles to be applied are those set out by Henderson J as approved by and elaborated upon by the Supreme Court. So far as material to this appeal, they may be summarised in the following propositions:
>
> i) The scope and subject matter of an appeal are defined by the conclusions stated in the closure notice and by the amendments required to give effect to those conclusions.
>
> ii) What matters are the conclusions set out in the closure notice, not the process of reasoning by which HMRC reached those conclusions.
>
> iii) The closure notice must be read in context in order properly to understand its meaning.

> iv) Subject always to the requirements of fairness and proper case management, HMRC can advance new arguments before the FTT to support the conclusions set out in the closure notice.

In point (iv), Kitchin LJ is clearly not saying that there is a discretionary case management power for the FTT to permit HMRC to advance new conclusions before the FTT. That would be at odds with the rest of the decision in *Fidex* and indeed the decision in *Tower MCashback*. Rather the point being made is that, subject to requirements of fairness and proper case management, HMRC are free to advance new arguments in support of the existing conclusions (set out in the closure notice).

14. The relevant paragraphs of the HMRC's closure notice for 2006-07 are as follows:

> **Vaccine Research Limited Partnership (the "Partnership")**
>
> **Partnership Tax Return for the year ended 5 April 2007**
>
> …
>
> I have now concluded my enquiries into the Partnership Tax Return for the year ended 5th April 2007….
>
> My conclusion is that the Partnership was not carrying on a trade in the UK (or at all). Alternatively, the Partnership has not incurred expenditure qualifying for Capital Allowances under s437 CAA 2001 or any other section of the Taxes Act. Alternatively, the Partnership has not incurred expenditure that is deductible in computing the profits of a trade.
>
> I have amended the partnership loss figure to reflect this. The figure for the partnership loss is as follows:
>
> - The original Partnership loss figure was £109,468,129
> - The amended Partnership loss figure was £192,702,989
> - The Partnership loss figure is now £nil.

15. The closure notice is clear. The "conclusions" are set out in the second paragraph and are expressly labelled as conclusions. One of HMRC's conclusions is that the Partnership was not carrying on a trade in 2006-07. The third paragraph quoted above does not set out "conclusions", it sets out adjustments to the Partnership tax return that are necessary to give effect to conclusions.

16. Read literally, the closure notice is putting in issue the question of whether the Partnership is carrying on a trade at all, not the characterisation of income that it received or the quantification of its taxable income. However, as Lord Walker explained in *Tower MCashback,* in issuing a closure notice, HMRC are "performing an important public function in which fairness to the taxpayer must be matched with a proper regard for the public interest in the recovery of the full amount of tax payable." Moreover, at [51] of his decision in *Fidex* Kitchin LJ concluded that "it is not appropriate to construe a closure notice as if it is a statute or as though its conclusions, grounds and amendments are necessarily contained in watertight compartments, labelled accordingly". Therefore, I do not consider that the construction of closure

notices should be approached simply as exercises in literal construction particularly where there is a risk of unfairness to the taxpayer.

17. Here, an exercise based on pure literal construction could produce unfairness. If the FTT had accepted HMRC's argument that the Partnership was not carrying on a trade at all, the Partnership would suffer the adverse consequence that it was not entitled to capital allowances. However, if the Partnership was not carrying on a trade, it must follow that it was not in receipt of any trading income although its income might still be taxable (for example as "miscellaneous income" taxable under Part 5 of the Income Tax (Trading and Other Income) Act 2005 or as "annual payments"). Therefore, if the FTT concluded that the Partnership was not trading that would naturally and inevitably give rise to the question whether income that the Partnership had assumed was taxable trading income was taxable at all. A purely literal construction of the closure notice that rendered such a question "off limits" runs the risk of not being fair.

18. A similar consideration arises if, as happened, the FTT concluded that some of the Partnership's activities were "trading" and some were not. In such a case, the natural and inevitable question was as to the tax status of income that was not connected with "trading" activities and there would be a similar risk of unfairness if that question were "off limits".

19. Mr Yates urged me to conclude that, because the Partnership had included licence fee income within the computation of its trading profits in its 2006-7 partnership return, by permitting the Partnership to argue that this was not taxable income, the FTT would be permitting the Partnership effectively to appeal against its own self-assessment. I do not accept that submission. When the Partnership submitted its self-assessment return, it evidently thought that all of its activities were "trading" in nature. The FTT and the Upper Tribunal disagreed with the Partnership's analysis and concluded that only part of its activities were trading. Therefore, circumstances changed between the submission of the partnership return and the release of the FTT's and Upper Tribunal decisions. The Partnership is not seeking to appeal against its original partnership return: it is asking for full effect to be given to the decisions of the FTT and Upper Tribunal.

20. Similarly, Mr Yates referred to the fact that, before both the FTT and Upper Tribunal, the Partnership relied on the receipt of the licence fees as demonstrating that it was carrying on a trade. However, in doing so, the Partnership was not conceding that if the FTT, contrary to its submissions, thought that the licence fees were not trading income, those licence fees remained taxable income of some other type (for example, annual payments or miscellaneous income)[2].

21. At [42] of the Court of Appeal's decision in *Tower MCashback v HMRC* [2010] EWCA Civ 32, Moses LJ said:

[2] Below I will consider the separate, but related, question of whether, because of the positive case that the Partnership and Mr Vaughan were making in the earlier appeals, I should exercise a case management power to preclude them from now arguing that licence fees are not taxable income in 2006-07.

> Provided a party can be protected from ambush, the only limitation on issues which might be entertained by the Special Commissioner is that those issues must arise out of the subject-matter of the enquiry and consequently its conclusion, and be subject to the case management powers to which I have referred.

22. Applying that approach, I have concluded that the question whether licence fees are taxable income in 2006-07 did "arise out of the subject-matter" of HMRC's enquiry as to whether the Partnership was trading. Moreover, HMRC had control over the drafting of the closure notice that they issued and I consider it would be unfair to give that closure notice a purely literal construction that might deprive the Partnership and Mr Vaughan of the ability to raise arguments favourable to them that arise out of that subject-matter. Therefore, construing the closure notice fairly it was open to the FTT in 2012 to entertain questions as to whether licence fees that the Partnership received in 2006-07 were taxable since such questions arose as a natural and inevitable consequence of the FTT's determination of the conclusions set out in the closure notice.

Aspects of the FTT and Upper Tribunal decisions on the licence fee issue

23. At [82] and [83] of the FTT Decision, the FTT expressed the conclusion that the licence fees were not trading income in 2006-07. It did so because of its conclusion that the Partnership's trade consisted of activities that it conducted with PepTcell Limited and the guaranteed licence fees were not part of those activities[3]. The Upper Tribunal endorsed the FTT's approach at [82] and [83][4].

24. However, having concluded that the guaranteed licence fees were <u>not</u> trading income, the FTT did not conclude positively on what those licence fees <u>were</u> (for example, whether they represented "miscellaneous income" that could be taxed under Part 5 of the Income Tax (Trading and Other Income) Act 2005). At [92] to [94] of the FTT Decision, the FTT concluded its decision as follows:

> 92 We allow the appeal on behalf of the Appellants in part but not in full. We find that the appeal is to be allowed to the limited extent that the Class B Limited Partners may claim research and development allowances in respect of their appropriate shares of the total sums incurred by them in funding PepTcell Ltd to the extent of £14 million to conduct relevant research and development for them. And they are entitled to deductions for interest under section 362 for their loans to the extent that these loans were used for trading income.

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[3] The FTT's conclusions to this effect appear in a section of the FTT Decision dealing with the commercial basis issue. However, I do not read their conclusions as relating only to that issue.

[4] The Upper Tribunal considered the point in connection with the quantum issue. In essence, in reliance on the FTT's conclusion that the financing arrangement involving the guaranteed licence fees was not a trading activity, the Upper Tribunal concluded that the Partnership's expenditure attributable to that financing arrangement was not "qualifying expenditure" as it was incurred in order to produce guaranteed licence fees (and not in connection with a trade). Nevertheless, the Upper Tribunal was clearly declining to interfere with the FTT's conclusion that the activity of generating licence fees was no part of the Partnership's trade.

> 93 We therefore decide that the decisions against which the appeals are made cannot stand without modification. However, we have not heard from the parties about the precise amounts that Mr Vaughan and the other Class B Limited Partners may claim. Nor do we have appropriate figures readily to hand.
>
> 94 We therefore reach this decision as a decision in principle. If the parties are unable to reach agreement on the precise sums to be included in the decisions under appeal to make them consistent with this decision then they are at liberty to seek a further hearing of the tribunal to determine the matter fully.

25. Paragraph [92] allows the appeal to a "limited extent" and does not mention the determination of taxable income. However, paragraph [94] includes a broader invitation to the parties to agree "precise sums" which does not expressly exclude the determination of the amount of the Partnership's taxable income, in the light of the FTT's findings on the limited extent of its trade. Therefore, while neither paragraph [92] or [94] expressly invite the parties to return to the FTT with arguments on the character of the licence fees, neither do those paragraphs expressly exclude the possibility.

26. Overall, I have concluded that the FTT, while having the power to consider the extent to which licence fees were taxable income, did not express a concluded view on the issue. The Upper Tribunal similarly expressed no concluded view.

The exercise of case management powers

27. It follows from the above that the FTT expressed no concluded view on the extent to which licence fees were taxable income in 2006-07 despite having power to do so. The Upper Tribunal similarly expressed no concluded view in the Upper Tribunal Decision. In this section, I will consider how the Tribunal should exercise its case management powers to decide whether, and if so on what terms, to permit the appellants now to make arguments on the character of the licence fees in 2006-07. As noted above, it is important that the Tribunal makes case management directions that are fair and avoid either party being "ambushed". Moreover, the Tribunal is entitled to expect that litigants will conduct litigation proportionately.

28. Mr Yates' skeleton argument (and his oral submissions at the hearing) focused on his point that neither the Partnership nor Mr Vaughan made any argument about the status of licence fees at any point up to or including the hearings before the FTT and Upper Tribunal. Indeed, they had both made a positive case that the licence fees were taxable (trading) income. He criticised the appellants for not doing so, but I consider there is little force in that criticism. Until the hearing before the FTT, the appellants were making a case that all of the Partnership's activities were of a "trading nature". They could not have known, until the FTT released its decision, that the FTT would conclude that only part of the activities were "trading" and therefore the appellants cannot have been expected to make a case before the FTT that some of the licence fees were not taxable income. The appeal to the Upper Tribunal was concerned largely with whether the FTT's findings of fact were sustainable (with the appellants submitting that they were not). In those circumstances, it is difficult to see how the appellants could

sensibly have raised an argument as to the character of the licence fees in the Upper Tribunal either.

29. Mr Yates did not submit that HMRC had been prejudiced by any delay, following the release of the Upper Tribunal's decision, in raising the character of the licence fees as an issue for 2006-07. In any event, there is no doubt that HMRC will have to meet the point in relation to the Partnership's appeal against HMRC's closure notices for 2013-14 and 2014-15. Mr Yates did not suggest that it would be materially more difficult for HMRC to meet the point in relation to the 2006-07 year than for the 2013-14 or 2014-15 tax years.

30. I therefore see no case management reason why I should restrict the Partnership's or Mr Vaughan's ability to raise the question whether the licence fees are taxable income in 2006-07.

Disposition

31. My overall conclusion on the main point of contention between the parties is that the Partnership and Mr Vaughan are entitled to raise an argument before the FTT that, in the tax year 2006-07, guaranteed licence fees that the Partnership received were not taxable income. I will release separate case management directions to the parties to give effect to my decision and to enable the various appeals to proceed to hearing.

32. 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 Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. 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.

JONATHAN RICHARDS
TRIBUNAL JUDGE

RELEASE DATE: 10 October 2018