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Insights

A CAPITAL BLOW FOR DEDUCTING MANAGEMENT EXPENSES

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SUMMARY

The Supreme Court confirmed in *Centrica Overseas Holdings Ltd v HMRC* that the tests for trading and management expenses of a capital nature are the same. The decision also confirms that once a company has decided in principle to dispose of a capital asset, any professional fees incurred afterwards in pursuance of that sale are likely to be capital and not deductible under CTA 2009 s 1219, even if a purchaser for that asset has not yet been identified and a specific sale transaction has not yet been agreed.

True story: on the morning of 18 November 2022, I was asked by a client to advise on the potential deductibility of certain transaction fees incurred in respect of a subsidiary which they had sold. After giving my thoughts, I had to ring them back later that evening to revise my advice, as the Court of Appeal had, earlier that day, delivered its judgment in *HMRC v Centrica Overseas Holdings Ltd* [2022] EWCA Civ 1520 overturning the Upper Tribunal's decision ([2021] UKUT 200 (TCC)) upon which I had heavily relied!

There would have been no repeat scenario on 16 July 2024 when the Supreme Court delivered its judgment on the appeal ([2024] UKSC 25), agreeing with the Court of Appeal and finding unanimously for HMRC. The decision, written by Lady Simler, concluded that the management expenses in dispute were capital in nature and accordingly not deductible under CTA 2009 s 1219(3)(a).

So we have now seemingly reached the end of this litigation and, to the disappointment of my client (and perhaps many taxpayers), it is now clear that the same 'income versus capital' test for trading expenses also applies to management expenses. While the facts in this case were key to the outcome, a broad principle has emerged that professional fees incurred in respect of the sale of a capital asset (such as a subsidiary) will not be deductible after the point at which a decision has been made in principle to sell (irrespective as to whether there is any uncertainty on the prospects or terms of the sale). However, given the importance of the facts, let's dive into them.

BACKGROUND FACTS

The taxpayer, Centrica Overseas Holdings Ltd ('COHL'), an intermediate holding company in the Centrica group, held a loss-making Dutch subsidiary, Oxxio. In June and July 2009, Centrica Plc decided to take steps to sell the Oxxio business. This was demonstrated by a kick-off meeting to achieve a 'going concern sale' (with attendees from Deutsche Bank, PwC and De Brauw Blackstone Westbroek), a board minute recording that Oxxio would be treated as a 'discontinued business held for sale' and a statement in their annual report and accounts that management had approved and initiated a plan to sell the business.

Deutsche Bank were engaged on a broad scope to advise on how to sell the Oxxio business. PwC's role was principally to prepare a VDD report which could be made available to potential purchasers (and they also prepared a 'deep dive' report on the difficulties in the business), and De Brauw acted as legal advisors (covering the drafting of the transaction agreements, structure of the sale and preparation of a virtual data room).

Unfortunately, the sale process proved difficult and a transaction to sell the business (in a different form than initially envisaged) did not take place until 2011. More specifically, the Centrica board approved the sale on 22 February 2011, and the transaction finally completed in March 2011.

COHL sought to deduct certain fees paid to Deutsche Bank, PwC and De Brauw between the decision in principle to sell (July 2009) and the board's decision to sell to the eventual buyer (February 2011) as expenses of management under CTA 2009 s 1219; anything incurred after that point was not claimed on the basis that they were expenses relating to the sale and not expenses of management. This reflected a relatively common approach taken by taxpayers historically that expenditure incurred on professional fees for the period prior to a board decision to sell pursuant to a specific transaction should still be deductible, but not for fees incurred after that point. However, HMRC disallowed the claim for relief of all the fees.

For COHL to succeed, they needed to establish that the fees were:

1. expenses of management; and

2. not expenses of a capital nature.

Following detailed judgments in the First-tier Tribunal (FTT) and Upper Tribunal (UT), most of the disputed fees were allowed. Much of the judicial consideration focused on the meaning of expenses of management which excluded any costs which formed part of the investment itself or could not be severed from it (i.e. those costs incurred after February 2011 which COHL did not seek to claim).

On the 'capital' question, the UT considered that most of the fees were revenue in nature, and that the capital exclusion must be more limited than in the context of trading businesses, and thus

aimed at expenses which do not normally recur but which have the effect of creating, enhancing or disposing of a capital investment. Indeed, the UT thought that Parliament may have been acting out of an abundance of caution by including the capital exclusion as most of the case law which examined the meaning of expenses of management was in the context of previous legislation which did not have the capital exclusion; nonetheless, it was decided in those cases that expenses of management did not include any costs of the relevant investment. Accordingly, the UT concluded that the test for what an expense of management is, and what a capital expense is in that context, must be similar.

While the Court of Appeal upheld the conclusion on whether the disputed fees constituted expenses of management, it allowed HMRC's appeal on the capital question, and ruled that the fees were of a capital nature and thus not deductible. The crux of its decision was that the UT was wrong to conclude that the tests for management and trading expenses of a capital nature were similar and should instead have analysed whether the expenses were capital in nature by reference to the 'well established principles' developed by the courts on the distinction between capital and revenue expenditure.

And so to the Supreme Court, where the only question to be answered was whether the disputed expenses were capital or revenue (it having been accepted that the fees were expenses of management).

COHL'S ARGUMENTS

COHL advanced two grounds of appeal:

- the Court of Appeal had erred in law in finding that the identification of what constitutes management 'expenses of a capital nature' is to be decided on the same principles applicable to expenditure that constitutes 'items of a capital nature' for trading companies under CTA 2009 s 53; and
- even if the Court of Appeal had applied the correct legal test, it had erred in its application to the findings of fact made by the FTT.

WHAT ARE MANAGEMENT EXPENSES OF A CAPITAL NATURE?

The Supreme Court noted that when the capital expenditure exclusion was first introduced in 2004 (by FA 2004 s 38), the tax code had a well-established history of the concept of expenditure of a capital nature, which Parliament must have been aware of. It would be surprising therefore, in their view, if the wording (which was the same as the equivalent carve out in CTA 2009 s 53) had a special narrower meaning without anything to signal that this was so. Lady Simler also adduced the relevant Explanatory Notes to support this conclusion.

Accordingly, they agreed with the Court of Appeal that the same principles are relevant to identify trading and management expenses of a capital nature and dismissed COHL's first ground of appeal.

WERE THE DISPUTED FEES CAPITAL IN NATURE?

One of the somewhat unhelpful features of the Court of Appeal decision was that there was not a lot of analysis on why the disputed fees in this case were, in fact, capital in nature. It is therefore welcome that the Supreme Court addressed this in more detail. It began by stating that this is a question of law, but that there is no single test that will be decisive in every circumstance.

Lady Simler stated that professional and advisory services fees that constitute expenses of management are capable of being revenue or capital in nature, and they take their character from the commercial or business transaction to which they relate. In this case, that transaction was the disposal of Oxxio, and, as 'a matter of objective analysis, once a commercial decision was taken to dispose of the Oxxio business [which in this case was taken to be June 2009], the services of [the professional advisers] were obtained precisely to enable management to achieve that disposal … in whatever form that transaction ultimately took'. Accordingly, as the purpose for incurring the fees was the disposal of a capital asset, the fees were held to be capital in nature.

It did not matter that some of those services included advice on issues that provided a wider benefit to COHL, such as the PwC 'deep dive' report, as that did not alter the fundamental nature of the expenditure or its objective purpose, i.e. the disposal of Oxxio. It also did not matter that there was uncertainty as to whether Oxxio would be sold; Lady Simler noted that expenditure on an abortive capital disposal transaction is capital expenditure nonetheless.

In its arguments, COHL relied on *Lawson (Insp of Taxes) v Johnson Matthey plc* [1992] 2 AC 324 where an injection by a parent company of £50m to a wholly owned subsidiary before its sale was held to be a revenue payment as it was made for the purposes of saving the parent's trade from collapse, but Lady Simler dismissed its relevance as having highly unusual and readily distinguishable facts (without, in truth, really exploring that in further detail).

Accordingly, the Supreme Court dismissed this ground of appeal also and ruled that the disputed fees were capital in nature and not deductible.

OBSERVATIONS AND IMPLICATIONS

It is notable that the decision resulted in all of the disputed fees being disallowed, due to the fact that COHL did not seek to draw a distinction between the different fees for different professional services. One cannot help but wonder whether COHL might have had some success for certain fees incurred that were not specifically focused on the sale of Oxxio if they had treated them separately in their appeal; however, they may have taken the view that the facts and evidence would not have

supported that argument and they might not have been able to clear the bar set by the Supreme Court that all of the services obtained were ultimately for the overall objective of the sale.

More broadly, the conclusion that the meaning of expenses of a capital nature is the same for management and trading expenses is not particularly surprising. However, it is somewhat of a shame that this conclusion has been reached without a detailed consideration of how it links with the test of what an expense of management is. For the latter, the UT held (and the Court of Appeal agreed) that there is a distinction between expenses incurred in deciding whether to acquire or dispose of an asset (which are expenses of management), and expenses incurred on the mechanics of implementation once that decision has been taken (which are not). Carrying out an analysis of that distinction seems somewhat pointless in future in the knowledge that the latter would almost certainly constitute capital expenditure in any case. In other words, what is the point of testing which costs were incurred before a decision to sell the asset was made, and which costs were incurred afterwards in determining whether the costs constitute expenses of management if the second test (whether they are capital or not) essentially asks a more expansive version of the same question? As there was no appeal on whether the disputed fees constituted expenses of management before the Supreme Court, there was no scope for this to be considered.

Lady Simler did take pains to list some expenses of management that were revenue in nature: day-to-day staff costs, rent, administration costs and repairs, for example. That still seems limited however and it is interesting to consider what the analysis would have been if the Centrica board had *not* made a strategic decision to sell the Oxxio business at the outset and the terms of their engagement with, for example, Deutsche Bank were to provide advice on how to increase or otherwise realise the value of their investment in Oxxio. If a sale followed the receipt of the advice, would it still be correct to disallow all of those fees even though the initial scope of the advice was not focused exclusively on a sale? At the very least, there seems to be some scope for arguing in those circumstances that fees incurred in respect of early advice which explored potential options should be deductible.

This is important as taxpayers may want to consider how they frame the engagement of any professional services in comparable situations and perhaps update the terms of engagement as a transaction proceeds. Of course, the tax deductibility of any fees will likely be a secondary consideration in these circumstances, but that does not mean it should not be considered, particularly if there are any distinguishing factors from this decision that might support deductibility. It will be interesting to see if these nuances are explored before the courts in future.

Nonetheless, the position now seems clear in circumstances where a decision has been made in principle to sell a subsidiary: any fees incurred afterwards in pursuance of that objective are unlikely to be deductible as expenses of management. Which, from a taxpayer perspective, is a capital shame!

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