TC01745

Appeal number TC/2009/11831

Corporation tax – capital allowances – finance lease of ship by Appellant – whether ship used for a qualifying purpose within terms of section 123(1) Capital Allowances Act 2001 – UK company taking bareboat charter of ship and hiring ship on time charter terms – whether ship let on charter in course of trade including operating ships – yes – whether responsible for navigating and managing the ship and for defraying substantially all operating expenses of ship – yes – whether section 123(4) Capital Allowances Act 2001 can apply where section 110 (rather than section 109) Capital Allowances Act 2001 is in point – yes – whether on facts one of main objects of the letting of the ship on charter or of any related transaction was to obtain capital allowances: section 123(4) Capital Allowances Act 2001 – no – appeal allowed

FIRST-TIER TRIBUNAL

TAX

LLOYDS TSB EQUIPMENT LEASING (N0 1) LTD **Appellant**

- and -

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

TRIBUNAL: EDWARD SADLER
ADRIAN SHIPWRIGHT (Tribunal Judges)

Sitting in public at The Royal Courts of Justice on 12 – 16 and 19 – 20 September 2011

Jonathan Peacock QC and Michael Ripley, counsel, instructed by Norton Rose, for the Appellant

David Ewart QC, Nigel Cooper QC, Raymond Hill, counsel and Stephanie Barrett, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

The decision under appeal

1. This is an appeal by the company Lloyds TSB Equipment Leasing (No 1) Ltd ("the Appellant") against an amendment made on 24 April 2009 by The Commissioners for Her Majesty's Revenue and Customs ("the Commissioners") to the Appellant's corporation tax self-assessment return for the year ended 30 September 2006.

2. The subject of that amendment, and of this appeal, is a claim made by the Appellant for writing-down capital allowances at the rate of 25 per cent in respect of expenditure incurred by the Appellant on the provision of two vessels designed and built to ship liquefied natural gas ("LNG") from northern Norway to Spain and the United States of America as part of a project for the exploitation of natural gas fields under the Barents Sea by a consortium of energy companies. The Appellant is UK tax resident and carries on a trade of finance leasing: it claims such allowances in the computation, for tax purposes, of the profits of that trade.

3. The total expenditure incurred by the Appellant on the two vessels was £198,226,884. The Appellant contracted to purchase the vessels in September 2002 and the vessels were delivered in the Appellant's accounting period ended 30 September 2006, when the greater part of the expenditure on the provision of the vessels was incurred. Instalment payments were made in earlier periods, and capital allowances were accordingly claimed in those earlier periods for such payments. In total, writing-down allowances of the amounts set out as follows were claimed by the Appellant in the respective years specified:

Year ended 30 September 2002	£3,882
Year ended 30 September 2003	£2,393,318
Year ended 30 September 2004	£3,964,216
Year ended 30 September 2005	£17,221,144
Year ended 30 September 2006	£33,351,994

4. The effect of the amendment made by the Commissioners to the Appellant's corporation tax return for the year ended 30 September 2006 is to deny the Appellant's claim to any capital allowances for its expenditure on the vessels and, by way of a balancing charge, to recover in full the allowances claimed and allowed in the earlier periods. The amendment results in an additional amount of corporation tax payable by the Appellant for the year ended 30 September 2006 in the sum of £6,278,877, and to certain penalties payable by the Appellant. The Commissioners' decision to deny the Appellant's claim to capital allowances for its expenditure on the vessels has significance beyond the amendment to its tax return for the year ended 30

September 2006, since, if upheld, that decision precludes the Appellant from claiming writing-down allowances for the balance of its expenditure on the vessels over subsequent accounting periods.

A summary of the factual background

5. The factual background to the dispute between the parties in this case as to the entitlement of the Appellant to claim capital allowances for its expenditure on the provision of the vessels can be summarised as follows:

(1) The natural gas fields under the Norwegian sector of the Barents Sea are being exploited by a consortium of energy companies ("the Snøhvit Sellers") who require a fleet of dedicated and purpose-built vessels to ship the natural gas, in a liquefied state, to its long-term customers. The two vessels acquired by the Appellant ("the Vessels") form part of that fleet;

(2) The Snøhvit Sellers, acting through the lead consortium member, the Norwegian energy company, Statoil ASA ("Statoil") sought an owner and operator of the Vessels who would hire the Vessels to the Snøhvit Sellers on a long-term time charter on commercial terms specified by the Snøhvit Sellers whereby the hire would reflect, over the time charter period, a return of the capital cost of the Vessels and a finance charge on such cost, and also the expenses (or an estimate of the expenses) of operating the Vessels. It was a requirement of the Snøhvit Sellers that, since the Vessels would operate only within the Atlantic Basin, the commercial and technical management of the Vessels in the course of their operation should be located in the European time zone;

(3) After a tender process the mandate to own and operate the Vessels was awarded to one of Japan's largest and oldest shipping companies, Kawaski Kisen Kaisha Limited ("K-Line"). K-Line had a strategic business plan to expand into the LNG carrier business and also to expand its business in Europe and the Atlantic Basin and to manage that business regionally. In December 2001 K-Line entered into the contracts with shipbuilders to purchase the Vessels (the Snøhvit Sellers having, in effect, negotiated the technical and commercial terms of the shipbuilding contracts to ensure that the Vessels met their stringent specifications and requirements) and also entered into the time charter. K-Line reserved the right to introduce other parties to co-own the Vessels, and also the right to re-structure ownership rights and arrangements to accommodate the financing of the Vessels (at the time it entered into the purchase contracts and the time charters, K-Line was actively exploring a number of financing options, including UK finance leases);

(4) At this time K-Line had a UK incorporated and resident subsidiary company, K-Line (Europe) Limited ("K-Euro") which had an established shipping trade comprising the operation of coastal container ships in European waters and a general agency for K-Line's container and car carrier business in Europe. K-Line intended that, howsoever the Vessels might be financed, K-Euro should be the company by which it met the requirements of the Snøhvit Sellers

for the commercial and technical management of the Vessels in the course of their operation to be located in Europe;

(5) In September 2002 K-Line had agreed financing for the Vessels on UK finance lease terms with the Appellant, and to effect such financing the following principal transactions took place at that time:

(a) The shipbuilding contracts for the Vessels were novated so that the Appellant contracted to purchase the Vessels;

(b) In the case of each Vessel respectively the Appellant granted a finance lease of the Vessel to a joint venture company ("Northern LNG"), the shareholders of which included K-Line and Statoil, on terms whereby the equity reversionary value in the Vessel resided in Northern LNG. The primary lease period of the finance lease was thirty years from delivery of the Vessel, with provision for renewable secondary lease periods of one year;

(c) Northern LNG entered into a bareboat charter of each Vessel with K-Euro for a twenty year period (with provision for extension for up to a further ten years) under which K-Euro was entitled to possession and use of the Vessel. The hire payable by K-Euro under the bareboat charter was fixed for the first twelve years and was expressed to be a fair commercial rate;

(d) The time charter for each Vessel between K-Line and the Snøhvit Sellers was novated so as to substitute K-Euro for K-Line as disponent owner;

(e) Detailed and complex security arrangements were put in place to safeguard the interests of the different parties and the flow of payments pursuant to the lease and ancillary arrangements.

(6) The business of K-Euro was expanded from 2002 onwards, in particular by the establishment of a bulk and gas carrier division. For the purposes of that business K-Euro took on time charter, or undertook the management of, a number of LNG and bulk carriers;

(7) With effect from 1 January 2006 the business of K-Euro was reorganised with the result that K-Euro retained its interest in the Vessels by reason of the bareboat and time charters described above, but it contracted out the management of the Vessels to a fellow subsidiary in the K-Line group ("K-LNG"), and also transferred to other fellow subsidiaries all other parts of its business. In addition, the hire payable by K-Euro under the bareboat charters was, for a specified period, reduced. Further (as part of this reorganisation, but not effected until October 2006), the share capital of K-Euro was reorganised so that its shareholders (and their respective shareholding interests) corresponded with those of Northern LNG and its shareholders contributed further share capital. This reorganisation was effected because it was anticipated that, contrary to original expectations, K-Euro would make a substantial loss in operating the Vessels and because certain of the security arrangements with respect to the lease structure through which K-Euro held its interest in the Vessels were proving to be a

commercial restraint upon the management and development of K-Euro's other business interests;

(8) The first of the Vessels was delivered in February 2006 and the second in July 2006. The leasing arrangements in relation to each Vessel took effect upon the delivery of the respective Vessels.

A summary of the basis on which the Appellant claims capital allowances

6. By way of further introduction to this case it is helpful to explain, again in summary, the basis upon which the Appellant claims capital allowances for its expenditure on the acquisition of the Vessels:

(1) Writing-down allowances at the rate of 25 per cent on a reducing balance basis are generally available to a person who is carrying on a trade and who incurs capital expenditure on the provision of plant or machinery for the purposes of that trade. The Appellant's expenditure on the Vessels is such capital expenditure;

(2) However, such allowances are (subject to certain exceptions) restricted, where such plant or machinery is used by a person who (in broad terms) is outside the scope of the UK tax charge ("overseas leasing"). Since in the present case the end users of the Vessels, pursuant to the time charters, are the Snøhvit Sellers (none of whom are liable to UK tax on their profits), the restrictions apply unless the circumstances come within one of the exceptions;

(3) Those restrictions may either be partial (so that the person incurring the expenditure can claim 10 per cent writing-down allowances rather than 25 per cent) or total (so that no allowances can be claimed). In the present case the circumstances of the Appellant's leasing of the Vessels (in particular, the circumstance that the primary period of the finance lease exceeds 13 years) are such that, if 25 per cent allowances are not available, than no allowances can be claimed;

(4) It is an exception to the restriction on allowances (so that 25 per cent allowances remain available) if the plant or machinery, although used for overseas leasing, is nevertheless used for a "qualifying purpose". Section 123 of the Capital Allowances Act 2001 ("CAA 2001") is relevant in this context to the Appellant's circumstances, since it provides that a ship will be used for a qualifying purpose (regardless of the identity of the end-user of the ship) where it is let on time charter terms by a person carrying on a trade of operating ships and that trade is within the UK tax charge. However, even if these requirements are met, the allowances can be denied if a main object of any of the transactions concerning the letting of the ship on time charter was to obtain 25 per cent writing-down allowances.

7. The Appellant contends that the leasing arrangements relating to the Vessels fall within section 123 CAA 2001 and that accordingly the Vessels are used for a "qualifying purpose" so that it is entitled to claim 25 per cent writing-down allowances.

8. The Commissioners contend that the circumstances of the time charter of the Vessels by K-Euro to the Snøhvit Sellers and the nature of the trade of K-Euro are such that the requirements of section 123 CAA 2001 are not met, and that, further, it was a main object of certain of the leasing transactions that 25 per cent writing-down allowances should be obtained by the Appellant. The Commissioners therefore deny the Appellant's claim to such allowances.

The significance of the legislative history of the "overseas leasing" provisions

9. Having outlined the capital allowance provisions relevant to this case, we should mention at the outset that the "overseas leasing" provisions, with which this case is particularly concerned, have a complex history, and that both parties, in their respective submissions as to the proper construction of those provisions, made extensive reference to that history. It will be necessary to refer in detail to the earlier legislation when considering those submissions, but it is helpful to set out at this point an overview of the development of those provisions.

10. The "overseas leasing" provisions (and the related "qualifying use" provisions) first appeared in section 64 Finance Act 1980, originally to limit capital allowances, where the asset was used by a person outside the UK tax charge, to 25 per cent writing-down allowances (rather than the 100 per cent first-year allowances then otherwise available): our understanding is that before that time entitlement had, in practice, been regulated under the exchange control rules (those rules were abolished in 1979).

11. Further changes were made in section 70 Finance Act 1982, introducing the restricted 10 per cent writing-down allowances for "overseas leasing", and denying all allowances in certain cases (broadly, where the lease terms included provisions which had the effect of skewing the lease or rental profile so as to exploit the availability of 10 per cent allowances).

12. The Finance Act 1982 also amended section 64 Finance Act 1980 by introducing a "main objects" provision in terms now recognisable in section 123(4) CAA 2001, but as a constraint upon a claim for first-year allowances only.

13. First-year allowances were phased out between 1984 and 1986, and the Finance Act 1986 made changes which related the "overseas leasing" and "main objects" provisions solely to writing-down allowances.

14. No further substantive changes were made to these provisions, but they were re-stated on consolidation of the capital allowances legislation in the Capital Allowances Act 1990, and were re-stated once again (and differently) in the course of the Tax Re-write project, in the legislation applicable in this case, the Capital Allowances Act 2001.

Previous judicial review proceedings

15. A further point must be mentioned by way of introduction. Pursuant to a long-standing and published practice, the Commissioners, when applying the "qualifying purpose" provisions of the capital allowances, have, where plant or machinery is leased and sub-leased in a chain of leases, had regard only to the end-user (and the final sub-lease in the chain) to determine whether or not the circumstances comprise a qualifying purpose. That practice was changed in February 2005, when the Commissioners announced that they would henceforth apply the qualifying purpose provisions by reference to any lease in a chain – the so-called "each lease" approach. They stated that such change in practice would not apply to transactions entered into before 3 February 2005.

16. The original statement of case prepared by the Commissioners in these appeal proceedings indicated that the Commissioners intended to argue that the Appellant was not entitled to claim capital allowances because the head lease was granted in circumstances where the use of the Vessels pursuant to the head lease did not comprise a qualifying purpose. The Appellant considered this to be contrary to the terms of the Commissioners' published practice with regard to transactions entered into before 3 February 2005, which included all the transactions relating to the leasing of the Vessels (all of which were entered into by 19 September 2002 at the latest). The Appellant therefore commenced judicial review proceedings in the High Court, seeking an order directing the Commissioners to apply their published practice.

17. The matter was resolved between the Appellant and the Commissioners before the Appellant's application was heard by the High Court. They agreed that, in these proceedings, the Commissioners would be bound by their practice as it stood before February 2005, so that they would not take any point, in respect of the qualifying purpose provisions, other than in relation to the end use of the Vessels under the time charter to the Snøhvit Sellers. They also agreed that the Commissioners, in arguing before this Tribunal their case as to the context and construction of the "main objects" provision in section 123(4) CAA 2001, could nevertheless make submissions as to the meaning and effect of section 123(4) CAA 2001 on the basis of the "each lease" approach. The agreement of the parties in this regard is set out in a consent order signed by the parties and stamped, by way of approval, by the High Court on 11 October 2010.

18. The terms of that consent order are binding upon us in terms of the arguments which we can hear in this appeal and the scope of our decision. We record that, in the case put before us, the parties complied with the consent order, and as it transpired the Commissioners did not, in advancing their arguments on the meaning and effect of section 123(4) CAA 2001, make any submissions with reference to the "each lease" approach.

Post-hearing written submissions

19. There is one final point to mention by way of introduction. It is a matter of procedure. At the hearing both parties made, in writing, substantial submissions on the evidence. In the closing stages of the hearing, in the course of his reply to the

Commissioners' case, Mr Peacock, appearing for the Appellant, handed up further written submissions which were by way of comment upon the Commissioners' written submissions on the evidence. Those submissions also referred to a number of documents from which the Commissioners had drawn certain inferences in the course of their submissions. Mr Peacock challenged the right of the Tribunal to take account of such inferences when neither the documents in question nor the inferences drawn from them had been put to the Appellant's witnesses in cross-examination by Mr Ewart, who appeared for the Commissioners in this case.

20. Mr Ewart pointed out that since the Appellant had not put forward witnesses who were in a position to comment on the documents in question, the Commissioners should not thereby be constrained from drawing inferences from those documents, but that it was for the Tribunal, in its evaluation of the evidence, to decide what significance to attach to the inferences drawn in these circumstances by the Commissioners.

21. Mr Ewart did not, at the hearing, indicate that he needed to comment on these further submissions in reply by the Appellant, but he said that he would, after the hearing, re-issue his own submissions on the evidence to correct certain typographical inaccuracies. What he then produced was a revised version of those submissions with detailed comment (as he explained it, by way of correction) on the points made by Mr Peacock in his reply.

22. The Appellant's solicitors wrote to the Tribunal objecting to this, as it sought to deny the Appellant the "final say" in the appeal process. They asked the Tribunal to disregard the Commissioners' revised submissions, or to give the Appellant a right to revise its own submissions so as to include a reply to the additional points made by the Commissioners. They also asked the Tribunal to make an award of costs against the Commissioners on an indemnity basis for the costs of the Appellant in dealing with this issue of the Commissioners' revised submissions.

23. We took the view that the Tribunal could not simply disregard the revised submissions made by the Commissioners: those submissions, to the extent they were revised, in part purported to be corrections of inaccuracies in the Appellant's reply, and if that were indeed the case justice would best served by taking account of such submissions. It was equally clear to the Tribunal that the fairness inherent in the normal hearing process required that the Appellant should have the opportunity to reply to such submissions, at least to the extent that matters had not fairly been dealt with in the Appellant's reply at the hearing itself.

24. We therefore informed the parties that we would allow the Appellant an opportunity to reply in writing to the Commissioners' revised submissions, but that thereafter there would be no further submissions by either party other than at the request of the Tribunal. We decided that we would make no order as to the additional costs of the Appellant: in part this situation had arisen because the Commissioners had not been given the opportunity to consider the Appellant's extensive written reply submissions before the end of the hearing. In our view these further costs should, as part of the costs of the appeal, follow the cause.

25. The Appellant duly made further written submissions in reply to the Commissioners' revised submissions.

26. As to the question of the inferences which the Commissioners invited us to draw from the documents which were not put to the Appellant's witnesses, we deal with this below at paragraphs 117 to 119 below.

The issues to be determined and our decision

27. The parties agreed that there are four issues in dispute between them which require our determination and which, together, determine whether or not the Appellant is entitled to the 25 per cent writing-down allowances it has claimed.

28. In order to state those four issues, which all relate to the question of whether the Vessels are used for a qualifying purpose within the provisions of section 123 CAA 2001, it is necessary to set out those provisions. So far as material to this case they are as follows:

> *(1) A ship is used for a qualifying purpose at any time when it is let on charter in the course of a trade which consists of or includes operating ships by a person who is—*
>
> *(a) resident in the United Kingdom or carries on the trade there, and*
>
> *(b) responsible for navigating and managing the ship throughout the period of the charter and for defraying—*
>
> *(i) all expenses in connection with the ship throughout that period, or*
>
> *(ii) substantially all such expenses other than those directly incidental to a particular voyage or to the employment of the ship during that period.*
>
> *(2) …*
>
> *(3) For the purposes of subsection (1)(b) a person is responsible for something if he—*
>
> *(a) is responsible as principal, or*
>
> *(b) appoints another person to be responsible in his place.*
>
> *(4) Subsections (1) and (2) do not apply if the main object, or one of the main objects—*
>
> *(a) of the letting of the ship … on charter,*
>
> *(b) of a series of transactions of which the letting of the ship … on charter was one, or*
>
> *(c) of any of the transactions in such a series,*

was to obtain a writing-down allowance determined without regard to section 109 (writing-down allowances at 10%) in respect of expenditure incurred by any person on the provision of the ship or aircraft.

The issues

29. The four issues are centred on the role and trading activities of K-Euro, the time charter by which it hired the Vessels to the Snøhvit Sellers, and the transactions by which it entered into the hiring of the Vessels by taking the bareboat charter and a novation of the time charter. It is agreed by the parties that at all material times K-Euro was resident in the UK.

30. The four issues are as follows:

Issue 1: Whether K-Euro is responsible for defraying all, or substantially all, expenses in connection with the Vessels under the time charter throughout the charter period, within the meaning of section 123(1) CAA 2001.

Issue 2: Whether K-Euro lets the Vessels on charter in the course of a trade which consists of or includes operating ships, within the meaning of section 123(1) CAA 2001.

Issue 3: Whether (because section 123(4) CAA 2001 refers to the objective of obtaining writing-down allowances determined without regard to section 109 CAA 2001 (which denies 25 per cent allowances but allows 10 per cent allowances instead where there is overseas leasing and no qualifying purpose)) section 123(4) CAA 2001 can apply in the circumstances where section 110 (rather than section 109) CAA 2001 is in point, namely where there is overseas leasing and no qualifying purpose but the taxpayer is entitled to no allowances instead of 10 per cent allowances.

Issue 4: Whether (if Issue 3 is determined so that in principle section 123(4) CAA 2001 applies) the main object, or one of the main objects, of any transaction or series of transactions which includes the letting of the Vessels on charter was to obtain the 25 per cent writing-down allowances claimed by the Appellant.

31. It will be apparent that Issues 1, 2, and 4 are to be determined largely on the facts and the terms of the documents by which the parties entered into the relevant transactions. Issue 3 is a matter to be determined solely by construing the relevant statutory provision (it being common ground between the parties that section 110 (and not section 109) CAA 2001 is relevant to the circumstances of the Appellant, in that if there is no qualifying purpose, no allowances, rather than 10 per cent allowances, are available to the Appellant).

32. There is some logic to the approach adopted by Mr Ewart, appearing for the Commissioners, in his submissions, of taking Issue 4 first, since if it is the case that a main object of the relevant transactions was to obtain 25 per cent writing-down allowances, that determines the matter against the Appellant without further enquiry.

However, since we are required to reach a decision on each Issue we will consider them in the sequence which follows from the reading of section 123 CAA 2001.

The decision

33. As to Issue 1, it is our decision that K-Euro is responsible for defraying all, or substantially all, expenses in connection with the Vessels under the time charter and throughout the period of the charter.

34. As to Issue 2, it is our decision that K-Euro lets the Vessels on charter in the course of a trade which consists of or includes operating ships.

35. As to Issue 3, it is our decision that section 123(4) CAA 2001 can apply in the circumstances where section 110 (rather than section 109) CAA 2001 is in point, and can therefore in principle apply to the circumstances of the Appellant's claim for writing-down allowances for its expenditure on the provision of the Vessels.

36. As to Issue 4, if (as we have decided in Issue 3) in principle section 123(4) CAA 2001 can apply in circumstances where section 110 CAA 2001 has effect to deny a person all allowances, then it was not a main object of any transaction or series of transactions which includes the letting of the Vessels on charter to obtain the 25 per cent writing-down allowances claimed by the Appellant.

37. We therefore allow the Appellant's appeal against the Commissioners' amendment, made on 24 April 2009, to the Appellant's corporation tax self-assessment return for the year ended 30 September 2006.

The relevant statutory provisions

38. Part 2 of CAA 2001 comprises the provisions which relate to capital allowances for capital expenditure incurred on the provision of plant or machinery. By virtue of section 11 CAA 2001 such allowances are available if a person carries on a "qualifying activity" (which includes a trade) and incurs capital expenditure on the provision of plant or machinery wholly or partly for the purposes of that qualifying activity. In the present case it is agreed that the Appellant carries on a trade; that the expenditure it has incurred on purchasing the Vessels is capital expenditure incurred for the purposes of that trade; and that such expenditure has been incurred on the provision of plant or machinery.

39. The general requirement in the case of plant and machinery is that all expenditure incurred by the taxpayer which qualifies for writing-down allowances is brought into a "pool" of expenditure to determine the amount, in each chargeable period, for which allowances may be claimed. The "pool" for any chargeable period takes into account new expenditure in that period, the residue of expenditure in prior periods for which allowances have not yet been claimed, and the proceeds of plant and machinery disposed of during that period. The net amount thus determined in that chargeable period is eligible for writing-down allowances at the rate (in the years with which this case is concerned) of 25 per cent. The balance of unallowed expenditure in that

"pool" for that chargeable period (that is, the 75 per cent) is carried forward to the "pool" for the following chargeable period. Sections 53 to 56 CAA 2001 set out these general rules.

40. The normal "pooling" rules are modified in the case of qualifying expenditure incurred on the provision of a ship, with further special provision if the ship is provided for leasing, and Chapter 12 of Part 2 of CAA 2001 sets out these provisions. No issue in dispute in this case turns on the "pooling" provisions.

41. We are, however, concerned in this case with the provisions of Chapter 11 of Part 2 of CAA 2001, which deals with "overseas leasing".

42. Section 105 CAA 2001 defines "leasing" to include letting a ship on charter, and provides that for the purposes of Chapter 11 references to a lease include a sub-lease. "Overseas leasing" is defined in these terms, by section 105(2) CAA 2001:

> *"Plant or machinery is used for overseas leasing if it is used for the purpose of being leased to a person who –*
>
> *(a) is not resident in the United Kingdom, and*
>
> *(b) does not use the plant or machinery exclusively for earning profits chargeable to tax."*

In the present case, since the Vessels are let on charter (which is by way of a sub-sub-lease) to the Snøhvit Sellers, none of whom are resident in the UK, and who do not use the Vessels for earning profits chargeable to UK tax, the Vessels are used for overseas leasing.

43. Section 105 CAA 2001 also defines "protected leasing", in these terms (section 105(5)):

> *"´Protected leasing' of plant or machinery means –*
>
> *(a) …, or*
>
> *(b) if the plant or machinery is a ship,… the use of the ship… for a qualifying purpose under section 123 or 124 (letting on charter to UK resident etc.)."*

44. Section 106 CAA 2001 deals with the concept of "the designated period", which is, in relation to expenditure incurred on plant or machinery, the period of 10 years beginning with the date on which the plant or machinery is first brought into use. In the present case the "designated period", in relation to each Vessel, begins on the delivery date of that Vessel, and will run for 10 years (or until the Appellant ceases to own the Vessel, should that occur before the 10 year period has expired).

45. Section 109 CAA 2001 applies to "expenditure incurred on the provision of plant or machinery for leasing if the plant or machinery is at any time in the designated period used for overseas leasing which is not protected leasing". In the case of such expenditure, the amount of the writing-down allowance to which the person incurring the expenditure is entitled in the relevant chargeable period is 10 per cent (rather than 25 per cent).

46. Section 110 CAA 2001 is headed "Cases where allowances are prohibited", and, so far as is relevant to this case provides as follows:

> *"(1) A person is not entitled to any writing-down or balancing allowances in respect of qualifying expenditure which is within subsection (2).*
>
> *(2) Expenditure is within this subsection if -*
>
> *(a) it is incurred on the provision of plant or machinery for leasing,*
>
> *(b) the plant or machinery is at any time in the designated period used for overseas leasing which is not protected leasing,*
>
> *(c) the plant or machinery is used otherwise than for a qualifying purpose (see sections 122 to 125), and*
>
> *(d) the lease is within any of the items in the list below.*
>
> *LIST*
>
> *Leases in relation to which allowances are prohibited*
>
> *1. The lease is expressed to be for a period of more than 13 years.*
>
> *2. …. "*

In the case of each Vessel the head lease (and also the bare boat charter and the time charter) is for a period of more than 13 years. Therefore section 110 CAA 2001 will apply to disentitle the Appellant from claiming any writing-down allowances for its expenditure on the Vessels unless it can establish that throughout the 10 year designated period, although the Vessels are used for overseas leasing, that leasing is nevertheless protected leasing, that is (see section 105(5)(b) CAA 2001), the Vessels are used for a qualifying purpose under section 123 CAA 2001.

47. This brings us to section 123 CAA 2001, whose application to the circumstances of the operation and chartering of the Vessels is the essential matter in dispute in this case. The Appellant contends that those circumstances fall within the scope of section 123 CAA 2001 so that the Vessels are used for a qualifying purpose, and hence the leasing of the Vessels is protected leasing, so that neither section 110 CAA 2001 applies to prohibit it from claiming any writing-down allowances, nor section 109 CAA 2001 applies to restrict its claim to writing-down allowances at the reduced 10 per cent rate. The Commissioners contend that those circumstances do not fall within the scope of section 123 CAA 2001, so that the Vessels are not used for a qualifying purpose, and therefore the leasing of the Vessels is not protected leasing. In consequence, by virtue of the term of each lease in the chain by which the Vessels are let, section 110 CAA 2001 applies to the Appellant's circumstances, and no writing-down allowances can be claimed.

48. Section 123 CAA 2001, to the extent material to this case, is set out at paragraph 28 above.

The Statement of Agreed Facts

49. The parties lodged with the Tribunal a Statement of Agreed Facts, in the terms set out in paragraphs 50 to 102 following.

The parties

50. The Appellant is a company incorporated and tax resident in the United Kingdom. It is a wholly-owned subsidiary of what is now the Lloyds Banking Group. The Appellant carries on a trade of finance leasing. The Appellant is the owner of two LNG vessels (the "Vessels").

51. The Respondents are the Commissioners for Her Majesty's Revenue & Customs.

Other relevant entities

52. Each of Northern LNG Transport Co., I. Ltd ("Northern LNG I") and Northern LNG Transport Co., II Ltd ("Northern LNG II", and together with Northern LNG I, "Northern LNG") are, and were at all material times, the lessee of one Vessel from the Appellant. Northern LNG I and II were incorporated under the laws of the Cayman Islands in 2002 and registered in the Cayman Islands. Northern LNG I and II are tax resident in the Cayman Islands. The shares of Northern LNG are owned by Kawasaki Kisen Kaisha, Ltd, Mitsui & Co. Ltd, Statoil ASA, and Iino Kaiun Kaisha, Ltd. (together, the "Snøhvit Sponsors") in the following proportions:

	Northern LNG I	Northern LNG II
K-Line	49%	36%
Statoil	14%	50%
Mitsui	20%	9%
Iino	17%	5%

53. In turn, the Vessels are leased by Northern LNG to Polar LNG Shipping (UK) Ltd (formerly known as K-Line (Europe) Limited), a company incorporated under the laws of England and Wales in 1987 and registered in England under company number 02205323 ("K-Euro"). K-Euro is tax resident in the UK.

54. K-Euro was, at the time the leasing transaction was entered into, owned as to 95% by Kawasaki (London) Limited, a company incorporated under the laws of England and Wales in 1956 and registered in England under company number 00569042, which was, in turn, an indirectly wholly-owned subsidiary of the global Japanese shipping and logistics company, Kawasaki Kisen Kaisha, Ltd, (known as "K-Line"). The remaining 5% of K-Euro's share capital was owned by K-Line. In 2004, Kawasaki (London) Limited sold its 95% holding in K-Euro to "K" Line

Holding (Europe) Ltd. "K" Line Holding (Europe) Ltd also purchased K-Line's holding in K-Euro at the same time. Kawasaki (London) Limited was then dissolved in 2005. Kawasaki (London) Limited (company number 05549644) is a dormant company, established in order to retain the company name. In 2006, K-Euro was renamed Polar LNG Shipping (UK) Ltd ("Polar") and there was a reorganisation of part of the K-Line group involving K-Euro. As a result of that reorganisation, the shares in K-Euro (now Polar) are held by "K" Line Holding (Europe) Limited (49% A shares, 36% B shares), Statoil ASA (14% A Shares, 50% B shares), Mitsui & Co. Limited (20% A shares, 9% B shares) and Iino Kaiun Kaisha, Ltd (17% A shares, 5% B shares).

The global LNG market

55. LNG is natural gas which has been converted, temporarily, into liquefied form for ease of storage and transportation. LNG is shipped in specialised refrigerated tankers, such as the Vessels. Natural gas is transported by ship as LNG where transportation of natural gas by pipeline is not practical.

56. The global LNG market is characterised by long term supply contracts, due to countries' needs to ensure energy security, and the very high development costs for projects. Unlike vessels used to transport other commodities such as coal and oil, the "spot" market for LNG vessels is small. Currently, approximately 90% of the LNG shipping fleet is tied into servicing long term contracts, with vessels typically being built to service a particular project.

57. Vessels are highly specialised and require a high degree of technical management and maintenance to ensure that they are able to fulfil such contracts, particularly as little tonnage is available on a spot basis to move cargo should the contracted ship be off-hire. Further, the engines and propulsion systems of LNG vessels are not the same as those used by other vessel classes, and therefore require specific expertise.

History of the K-Line group's presence in the UK and development of the LNG business

58. The first company in the K-Line group, Kawasaki Kisen Kaisha Ltd ("K-Line") was established in Japan in 1919. K-Line is one of Japan's largest shipping companies, and has pursued its shipping activities on a global basis.

59. In 1927, Kawasaki & Co., Ltd (London) was established. The company carried out various shipping related activities, including chartering, collection of freights, and payment of disbursements, as a representative of the K-Line head office in Japan. The office closed in 1934, due to the decline in the worldwide tramp business as a result of the Great Depression.

60. In 1956, Kawasaki (London) Limited was established as a subsidiary of K-Line. Kawasaki (London) Limited acted in a representative capacity for K-Line for their liner service, fuel contracts, charter parties and insurance contracts. Kawasaki

(London) Limited did not have an agency function: K-Line used a third party agent until the establishment of K-Euro.

61. In the late 1970's, the K-Line group began to carry out LNG business relating to imports of LNG to the Japanese market.

62. In 1983, Japan's first LNG carrier, the "Bishu-Maru", was delivered. This vessel was jointly owned by K-Line, Nippon Yusen Kabushiki Kaisha (NYK) and Mitsui OSK Lines Ltd (MOL), and technically operated by K-Line. The K-Line group's move into LNG business was part of a national project in Japan to develop LNG as an energy source (Japan being a resource poor country).

63. K-Euro was incorporated in 1987. At the time of its incorporation, its function was to act as K-Line's general agent in Europe, to supervise third party agency companies. Japanese expatriates, who were in charge of container and car carrier business, were transferred from Kawasaki (London) Limited to K-Euro.

64. As the Japanese domestic market became saturated, in the late 1990's the K-Line group started to investigate business opportunities in the bulk and gas markets for transportation in the Atlantic basin.

65. Since the late 1990's the K-Line group has participated in large scale LNG transport business starting with transport of LNG from Qatar to Japan, followed by projects such as Petronet (Qatar to India) and RasGas II (Qatar to Europe), as well as the Snøhvit project.

66. In addition to K-Euro's agency function, from 1995 to 2004 K-Euro conducted a European coastal container business as an independent business, rather than as agent. Accordingly, K-Euro issued its own bills of lading, and profits and losses arising from this activity were for K-Euro's account. In 2004, this business was transferred to K-Line due to K-Line group's internal business restructuring.

The Snøhvit project

67. The Snøhvit LNG project is a joint venture set up to extract, process and deliver to market LNG from the Snøhvit, Albatros and Askeladd gas fields in the Barents Sea off the north-west coast of Norway. The original project partners were Statoil, Petoro AS, TotalFinaElf, Norsk Hydro, Amerada Hess, RWE-DEA and Svenska Petroleum. In their capacity as sellers of the LNG, and time charterers of the LNG vessels, Statoil (handling the interest of Petoro), Norsk Hydro, Amerada Hess, RWE-DEA and Svenska Petroleum are referred to as the "Snøhvit Sellers". Since the transaction was entered into, there have been changes made to the participants in the Snøhvit Sellers and currently, the Snøhvit Sellers consist of Statoil ASA only.

68. These gas fields, which were first discovered in the 1980s, have estimated reserves of 193 billion cubic metres of LNG, 17.9 million cubic metres of condensate and 5.1 million tonnes of natural gas liquids. The development of the gas fields was authorised by the Norwegian Parliament in 2002 and construction on the project

began in late 2003. The Snøhvit and Albatross fields came onstream in 2007, while the Askeladd field is due to come onstream in 2014-15. It is estimated that production will continue until 2035.

69. Snøhvit was the first project in Europe to be based on the export of LNG, previous gas projects having transported gas by pipeline.

70. Due to the location of the Snøhvit gas field in the high north, the LNG vessels which service the field are "winterised" (winterised vessels have design features to aid the safe operation of the vessel by the crew in winter weather conditions, so for example, the bridge will be enclosed) or have other special features in order to meet the requirements of the facilities.

71. The Snøhvit Sellers originally sold the LNG produced at Snøhvit under long term contract to the El Paso Corporation (for shipment to the US east coast) and Iberdrola (for shipment to Spain). GdFSuez and Total lift and sell their share of the LNG produced. At full capacity, the plant can produce about 4.3 million tonnes of LNG a year from the Snøhvit fields, corresponding to one cargo every five or six days.

The tender process for the Snøhvit project

72. Statoil led the tender process for selection of a counterparty. The tender process involved a very detailed consideration of shipyards and operators to ensure that they would meet the high standards required by the Snøhvit Sellers.

73. The tender process commenced in January 2001. At the first stage of the process (the "pre-qualification") Statoil identified owner/operators it considered were appropriate to be asked to indicate whether they were interested in participating. Owner/operators were selected in accordance with a detailed list of criteria including:

(1) Experience of operation of LNG ships;

(a) strong preference was given to owner/operators, rather than managers;

(b) Experience of North Atlantic trading was seen as essential;

(c) Establishment of management facilities in Europe was seen as essential;

(2) Financial strength and standing to perform a long term contract;

(3) Ship construction experience.

74. Approximately 55 companies were invited to participate in a pre-qualification process on the basis of selection criteria designed to establish the points identified above. The companies which responded were evaluated by Statoil using a comprehensive scoring system. Invitations to tender were sent to potential counterparties on 15 January 2001.

75. K-Line's initial evaluation was completed in early February 2001. K-Line scored well on all of the assessment criteria. K-Euro was identified as a suitable

management office in Europe. At this stage, the number of companies approved to tender for the project was reduced to 11.

76. On 23 April 2001 Statoil produced a document entitled "Evaluation Procedure for the Time Charter for LNG Carriers for the Snøhvit LNG Project" which sets out the detailed procedure for the evaluation of tenders, and the organisation of and responsibilities within the evaluation team. At this stage, the objective was for Statoil and the other Snøhvit Sellers to enter into a time charter directly with a ship owner. The criteria explored in the evaluation were:

(1) A financial evaluation of the time charter rate, based on certain assumptions; and

(2) A technical evaluation, to verify compliance with the technical and operational requirements identified in the pre-qualification process.

77. Also on 23 April 2001, K-Line submitted its first commercial offer. Under this offer, the Vessels were to be owned by an Owning Company to be owned and established by K-Line, but with K-Line retaining the option to invite other equity partners to participate in up to 49% of the shares.

78. Following this stage of the evaluation, the number of potential counterparties was reduced to 5. Statoil then met with these parties, meeting with K-Line on 5 June 2001.

79. K-Line's rebid was submitted on 15 June 2001.

80. Statoil met with K-Line for a project update meeting on 28 June 2001.

81. K-Line's second rebid was submitted on 2 July 2001.

82. On 10 July 2001, Statoil recommended to the Snøhvit management committee that the contract for the Vessels be awarded to K-Line. K-Line's contract was subject to the approval of the Snøhvit LNG project by the Norwegian Parliament.

83. K-Line's offer initially expired on 31 July 2001. Due to delays in the approvals process with the Norwegian Parliament, K-Line extended the validity of its offer twice: to 31 August 2001 and 12 September 2001. The approval of the Snøhvit project by the Norwegian Parliament took a long time. The Norwegian Parliament approval condition in K-Line's contract was lifted on 31 May 2002, after the Preliminary Stage (as defined in paragraph 84 below) had been entered into.

84. On 19 December 2001, K-Line entered into:

A shipbuilding contract with Mitsui Engineering & Shipbuilding Co., Ltd, in respect of the first Vessel;

A shipbuilding contract with Kawasaki Heavy Industries, Ltd in respect of the second Vessel;

Two time charterparties with Statoil (as operator on behalf of the Snøhvit Sellers); and

A memorandum of understanding (the "MOU") with Statoil.

Together, the arrangements above are referred to as "the Preliminary Stage".

Financing the Vessels

85. In order for K-Line to prepare its tender for the project, it was necessary to seek indicative pricing for financing the Vessels, so that a time charter day rate could be calculated. K-Line met with a number of institutions in order to discuss financing the Vessels.

86. In April 2001, K-Line discussed financing the Vessels with Christiana Bank in outline. The forms of financing discussed were debt financing, lease financing (UK, US, Spain, France or a Japanese operating lease) and securitisation of the project cash flows.

87. K-Line met with BNP Paribas in May 2001 to discuss financing of the Vessels over a 10 year term, and the possibility of French lease finance.

88. Meetings were also held with Den norske Bank and Mitsui & Co in June 2001.

89. Also between May and July 2001, K-Line met with;

(1) Capstar Partners, a leasing arranger now owned by BNP Paribas, together with UNI-ASIA, a debt and lease finance arranger specialising in Asian borrowers. Capstar Partners and UNI-ASIA put two proposals to K-Line for the financing of the Vessels, a defeased UK lease and a non-defeased UK lease;

(2) Citibank, whose proposal was to finance the Vessels with a project bond linked to a defeased UK finance lease; and

(3) New Boston Partners, a leasing arranger owned by the Bank of Tokyo-Mitsubishi.

90. New Boston Partners were mandated to arrange the financing of the Vessels on 27 September 2001.

91. The form of the financing to be utilised for the Vessels continued to be discussed between K-Line, the other Snøhvit Sponsors, and New Boston Partners between the date of New Boston Partners' mandate and the Preliminary Stage.

92. The Preliminary Stage, entered into on 19 December 2001, did not include any financing in respect of the Vessels. The MOU recorded the parties' intention to seek lease financing in respect of the Vessels.

93. An Information Memorandum, relating to the proposed lease financing, was prepared by New Boston Partners, and sent to prospective lessor banks, in January 2002.

94. One of the prospective lessor banks was Lloyds TSB Leasing Ltd.

95. Heads of terms for the financing of the Vessels were entered into between the Snøhvit Sponsors, Northern LNG and Lloyds TSB Leasing Limited on 16 April 2002.

Documentation of the transaction

96. The following key transactions were entered into on 19 September 2002:

(1) Novation agreements, between the shipyards, K-Line, the Appellant and Northern LNG, pursuant to which certain of K-Line's obligations under the shipbuilding contracts were assumed by the Appellant and certain by Northern LNG and K-Line;

(2) Lease agreements (the "Headleases"), in respect of each Vessel, between the Appellant and Northern LNG, pursuant to which the Vessels were leased to Northern LNG on finance lease terms for a primary period of 30 years from delivery and for lessee renewable one-year secondary lease periods;

(3) Bareboat charters, in respect of each Vessel, between Northern LNG and K-Euro, pursuant to which K-Euro was entitled to possession and use of the Vessels over the 20 year bareboat charter period. The period may, under two options exercisable by K-Euro, be extended for a term of five years under each option.

(4) Time Charter novation agreements, between K-Line, the Snøhvit Sellers and K-Euro, pursuant to which the time charters entered into in respect of the Vessels on 19 December 2001, were novated by K-Line to K-Euro.

Later developments

97. With effect from 1 January 2006, K-Euro's business was reorganised. The reorganisation involved the following steps:

(1) The K-Euro LNG business, apart from the leases in respect of the Vessels, was transferred to K-Line LNG Shipping (UK) Ltd ("K LNG") ;

(2) The Bulk shipping business was transferred to K-Line Bulk Shipping (UK) Ltd ("K Bulk");

(3) A new company, named K-Line (Europe) Ltd was incorporated ("New K-Euro"); and

(4) The agency business in respect of the car carrier and container vessels was transferred to New K-Euro.

98. K LNG retained all of the ship management function in respect of the Vessels under a ship management contract.

99. The first Vessel, LNG carrier "Arctic Discoverer", was delivered in February 2006.

100. K-Euro changed its name to Polar LNG Shipping (UK) Ltd ("Polar") on 3 February 2006.

101. The second Vessel, LNG carrier "Arctic Voyager", was delivered in July 2006.

102. In October 2006 (after the delivery of both Vessels), the share ownership of Polar changed, so that "K" Line Holding (Europe) Limited held 49% of the A shares and 36% of the B shares, Statoil Hydro ASA held 14% of the A shares and 50% of the B shares, Mitsui & Co held 20% of the A shares and 9% of the B shares and Iino Kaiun Kaisha held 17% of the A shares and 5% of the B shares.

The evidence

Documents

103. We had before us extensive documentary evidence comprising the transaction documents; background, preliminary and advisory documents which resulted in the structure of the transaction; accounts and tax returns of the relevant companies; business strategy papers and proposals for the K-Line group of companies; board minutes of K-Euro and other companies involved in the transactions; summaries and explanations of the Snøhvit project, the LNG processes and the special requirements for LNG carriers; documents relating to the tender processes conducted by Statoil for the appointment of ship owners and shipbuilders; documents relating to the obtaining by K-Line of financing for the Vessels; documents in connection with, and giving effect to, the reorganisation of K-Euro's business in 2006; and correspondence (including email correspondence) between the parties, their advisers and lawyers and other relevant persons in relation to the foregoing. In all the documentary evidence filled 30 lever arch files. The transaction documents in evidence related to the Vessel "Arctic Discoverer" (Ex Hull No 1564): we were told that the transaction documents relating to the other Vessel, "Arctic Voyager" were, in all material respects, in identical form.

Witnesses

104. Four witnesses gave evidence for the Appellant, and each had prepared a detailed witness statement. The witnesses were Mr Steinar Thomassen, formerly of Statoil; Mr Hiromichi Aoki of K-Line; Mr Akira Misaki, also of K-Line; and Mr Richard Owen Williams of Lloyds Banking Group. Mr Williams's evidence was not challenged by the Commissioners, and so we accept his evidence as given in his witness statement. The remaining three witnesses appeared before us, and were cross-examined by Mr Ewart. In giving their evidence Mr Aoki and Mr Misaki had the services of an interpreter, but for the most part their English was faultless, both as to their understanding of the questions put to them and as to their replies.

105. Mr Thomassen was until 31 December 2007 the manager of the LNG Shipping division of Statoil and as such had responsibility for the acquisition, construction and supervision of the LNG carriers for the Snøhvit project. He joined Statoil in 1987, and held a variety of positions within Statoil and affiliated companies, and since 1992 held senior management positions in various shipping divisions within the Statoil group.

106. Mr Thomassen's evidence related to the Snøhvit project; the processes whereby natural gas is turned into LNG and the special requirements of shipping tankers to transport LNG; the long-term LNG supply contracts entered into by the Snøhvit Sellers and their shipping requirements to enable them to carry out those contracts; the tender process for the shipbuilding and ship-owning contracts in relation to the Vessels; K-Line's tender in that process; the commercial requirements and objectives of Statoil and the other Snøhvit Sellers with regard to the operation and management of the LNG carriers; the role of Statoil and the other Snøhvit Sellers in specifying the terms of the time charter; his understanding of the terms of the time charter, especially with regard to the determination of the amount of hire payable by the time charterers; Statoil's attitude to, and involvement in, the financing by K-Line of the Vessels and its participation as a Snøhvit Sponsor in Northern LNG; the role of K-Euro; and the reasons for and implementation of the reorganisation of K-Euro's business and shareholdings in 2006.

107. We found Mr Thomassen to be an impressive and convincing witness.

108. Mr Aoki is a Managing Executive Officer of K-Line, with responsibility for all of the energy transportation business of the K-Line group, which includes vessels shipping crude oil, liquefied petroleum gas and LNG. Mr Aoki joined K-Line in 1981, and from 1990 worked on the development of new and existing projects for shipping LNG, initially projects shipping LNG to Japan. From July 2000 to March 2003 Mr Aoki was the manager of the LNG division responsible for the development of new LNG projects in the Atlantic Basin, and from the start of the Snøhvit tender process in early 2001 his principal role was to represent K-Line in all aspects of that process and the negotiation and implementation of the commercial and financing arrangements which resulted from that process. Mr Aoki was not, however, responsible for negotiating the financing of the Vessels by finance lease or for the decision to finance the Vessels by that means: colleagues of his in the finance department of K-Line had that responsibility. Mr Aoki was part of the project team within K-Line (which included his finance department colleagues) which jointly presented the proposals relating to the Vessels to the K-Line board for approval.

109. Mr Aoki's evidence related to the historic development of and background to the market in LNG, and K-Line's involvement in that market; K-Line's business strategy since 1998 and in particular its strategy to develop and operate from business hubs close to its clients and to expand its bulk and energy (including LNG) transport businesses in the Atlantic Basin; K-Euro's role in implementing that business strategy; K-Line's involvement in the Snøhvit project and the tender processes; K-Line's involvement in the time charter and his understanding of the terms of the time charter, especially with regard to the determination of the amount of hire payable by the time charterers; the options for financing the acquisition of the Vessels and the negotiation of the terms of such financing; the advice sought as to the requirements which had to be met in order that the lease financing should qualify for capital allowances; the reasons for bringing other shareholders into Northern LNG; the role of K-Euro within the lease structure and its anticipated profitability; and the reasons for and implementation of the reorganisation of K-Euro's business and shareholdings in 2006.

110.Mr Aoki, too, we found to be an impressive and convincing witness.

111.Mr Misaki is General Manager of the LNG Division of K-Line. He joined K-Line in 1983 and since July 2000 has worked in the LNG Division. Mr Misaki was not involved in K-Line's negotiations with the Snøhvit Sellers. In July 2002 he was seconded to the K-Line group's operations in London, where he remained until July 2008. He worked initially for K-Euro as General Manager of the new Bulk and Gas Division which K-Euro was establishing, in which position he had responsibility for the development of K-Euro's LNG business in the Atlantic Basin, including building commercial and technical expertise in readiness for the operation of the Vessels upon their delivery. Following the 2006 reorganisation of K-Euro Mr Misaki became a director of K-Euro and also Managing Director and General Manager of the commercial division of K-LNG.

112.Mr Misaki's evidence related to the business activities of K-Euro prior to its participation in the chartering of the Vessels; K-Euro's decision to participate in the chartering of the Vessels; the business plans for the expansion of K-Euro's business into LNG and bulk carrier operations and the execution of those plans (with particular reference to the development of the LNG operations); the development of K-Euro's LNG ship operation capability in readiness for operating the Vessels on their delivery; the staffing of K-Euro and its turnover and profits; the reasons for and implementation of the reorganisation of K-Euro's business and shareholdings in 2006; and the turnover and profits of K-Euro/Polar in the years following that reorganisation.

113.Again, Mr Misaki was an impressive and convincing witness.

114.The witness statement of Mr Williams records that he is a Director in the Shipping team which is part of the Structured Corporate Finance division of Wholesale Markets Treasury and Trading, Lloyds Banking Group. He joined the Lloyds group in 1988 and has worked exclusively in asset finance. Mr Williams had supervisory responsibility for the transactions in this case which the Appellant entered into.

115.Mr Williams's evidence related to the activities of banks in providing finance to their customers through leasing and the credit enhancement and security arrangements which such banks customarily require; the extent of such business undertaken by Lloyds group through its Lloyds TSB Leasing subsidiary companies and the business strategy of Lloyds in 2002 in relation to leasing generally and ship leasing in particular; the role of leasing advisors and arrangers in advising customers seeking lease financing of the structure and risk allocation in such financing; the review and consideration by Lloyds TSB Leasing of the proposals for the lease financing of the Vessels and the internal approvals sought and obtained within the Lloyds group; the credit enhancement arrangements included in the structure and the complex intercreditor provisions required to regulate those arrangements; the requirement of the Snøhvit Sellers to have untrammelled rights to use the Vessels to ensure the continuing conduct of the Snøhvit project, regardless of any enforcement of rights by financing parties; the tax assumptions underlying the lease financing and the financial consequences for the parties if those assumptions prove not to be correct; and the

documentation entered into on 19 September 2002 to effect the finance leasing transaction.

116. As mentioned, the evidence of Mr Williams was not challenged, and we accept it.

117. We make one further comment about the witness evidence. In the course of his cross-examination of Mr Aoki, Mr Ewart, by way of challenge to the Appellant's case, put to Mr Aoki a number of documents, email exchanges and the like relating to the advice which K-Line had received as to the requirements which must be met if a finance lessor is to obtain 25 per cent writing-down allowances by meeting the terms of section 123 CAA 2001. Mr Aoki was unable to comment on some of those documents since although they involved K-Line, it was clear that much of the detailed work relating to the consideration of these matters, the seeking of advice from external advisers, and the decision to proceed with this form of financing, was undertaken by colleagues of Mr Aoki in K-Line's finance department. As is apparent from the scope of Mr Aoki's evidence as outlined above, his primary focus was on the commercial aspects of the transaction, although Mr Aoki explained that within K-Line the matter was handled by a team (of which he was a member) drawn from different departments which worked closely together with team members contributing their respective expertises.

118. As we have already mentioned, in his written submissions on the evidence Mr Ewart drew a number of inferences from these documents and certain others which he had not put to Mr Aoki. In his reply Mr Peacock questioned Mr Ewart's right to draw such inferences and the right of the Tribunal to take account of them. Mr Ewart's response was that he had not put the documents to Mr Aoki for his comment since it was clear that he had no knowledge of or responsibility for them as they related to matters dealt with by his finance department colleagues, and those colleagues had not been put forward as witnesses by the Appellant.

119. We have some sympathy with Mr Ewart's position. It is, of course, for the Appellant to prove its case, and how it does so is its affair since it takes the risk of failing to do so. But if the witnesses it puts forward do not have the knowledge or experience enabling them to answer questions on documents produced in evidence then that should not preclude the Commissioners from drawing what appear to be reasonable inferences from those documents: the Appellant can rebut those inferences in its reply if those inferences are not it its view justifiable. It is not, in our view, open to the Appellant simply to say that such inferences must be disregarded because the documents have not been put to a witness when that witness was the person put forward by the Appellant in relation to the matters in question and he had no knowledge of the documents in question or of the circumstances surrounding them. We have therefore, in the course of evaluating and giving weight to the range of evidence before us, taken account of Mr Ewart's submissions in this regard, including the inferences he invited us to note, to the extent that we have considered them to be reasonable in the light of the evidence overall.

The transaction documents

120. As mentioned, we had in evidence all the transaction documents in relation to one of the Vessels, "Arctic Discoverer" (Ex Hull No 1564). They are extensive, as is to be expected for a substantial and complex financing and operating transaction involving a variety of parties with differing commercial interests. They fill eleven lever arch files.

121. The issues in this case are, however, centred on a small number of the principal documents, and in the course of the hearing many of the transaction documents were not referred to by either party. In particular, much of the documentation relates to the credit enhancement and security arrangements within the lease structure, and with a small number of exceptions this part of the documentation was not relied upon, or commented upon, by either party. We have therefore not felt it necessary to review that part of the documentation for the purposes of reaching our decision. In his witness statement Mr Williams set out a short description of all the transaction documents which relate to the transaction as it stood at 19 September 2002, and we have reproduced that in an Appendix to this decision.

122. In this part of our decision we set out, by way of our findings, the principal terms of the relevant transaction documents. For the most part there was no dispute between the parties as to the interpretation or effect of provisions of the transaction documents. Where there was such dispute (and this was principally in relation to the time charter of the Vessel – both as to the true nature of that charter and as to the hire payment provisions) we refer to that, and set out our findings as relevant, in our discussion of the Issue for which it is a material matter.

123. All the transaction documents referred to below are dated 19 September 2002, unless otherwise stated (the principal exceptions are the shipbuilding contract and the time charter, both of which were entered into on 19 December 2001, at the "Preliminary Stage" as it is referred to in the Statement of Agreed Facts). All the transaction documents are governed by English law.

The Shipbuilding Contract

124. The Shipbuilding Contract is dated 19 December 2001 and is between K-Line as Purchaser and Mitsui Engineering & Shipbuilding Co., Ltd as Builder. The principal provisions relevant for the purposes of this case are the following.

125. By Clause 2, the Builder agrees to design, build and complete the Vessel to the detailed specification and to specified performance and other standards, and the Purchaser agrees to accept Delivery of and pay for the Vessel. The Vessel is described as a 140,000m³ Moss-Rosenberg tank type Liquified Natural Gas Carrier with Hull No 1564.

126. Clause 3 specifies the price to be paid by the Purchaser for the Vessel. It is a fixed price of US$175,726,000. There is separate provision for the price of Depot Spare Parts. Clause 4 provides that the fixed price for the Vessel is payable by six

specified instalments on specified dates (the first of which is payable on 5 March 2002, and the final instalment is payable on Delivery).

127. Clause 9 deals with property and title, and provides that title to the Vessel passes to the Purchaser on completion of Delivery. Clause 13 provides that Delivery of the Vessel shall take place on 15 November 2005, or on an earlier date if both parties agree or on a later date if the Purchaser exercises a right to extend the Delivery date. The Builder is liable to pay liquidated damages at a specified daily rate if there is a delay in Delivery.

Novation Agreement in respect of shipbuilding contract

128. The Novation Agreement is between Mitsui Engineering & Shipbuilding Co., Ltd (the "Builder"), K-Line (the "Original Purchaser"), the Appellant (the "New Purchaser"), Northern LNG (as the fourth party, the "Replacement Purchaser", and as the fifth party, the "Lessee").

129. Key definitions include the "Vessel" (the LNG carrier identified as Builder's Hull No. 1564); the "Shipbuilding Contract" (the shipbuilding contract dated 19 December 2001 in respect of the Vessel, as above); the "Novated Rights" (all the obligations of the Original Purchaser under the Shipbuilding Contract, other than certain excluded rights relating to the right to receive liquidated damages in certain circumstances such as late delivery and rights to certain guarantees given by the Builder); and the "Novated Obligations" (all the obligations of the Original Builder under the Shipbuilding Contract, other than certain excluded obligations, which broadly correspond to the excluded rights).

130. By Clause 3 the Original Purchaser agrees to novate the Shipbuilding Contract to the New Purchaser and the Builder consents to such novation. The Original Purchaser releases and discharges the Builder from its obligations to the Original Purchaser in respect of the Novated Rights; the Builder releases and discharges the Original Purchaser from the Novated Obligations; the New Purchaser has the benefit of the Novated Rights (so that the Builder performs its obligations in respect of the Novated Rights in favour of the New Purchaser); and the New Purchaser assumes the Novated Obligations so that it is substituted in place of the Original Purchaser as a party to the Shipbuilding Contract.

131. There are corresponding novation terms in Clause 4 whereby the Original Purchaser novates the Excluded Rights to the Lessee and the Lessee agrees to perform the Excluded Obligations.

132. At the time of the Novation Agreement K-Line had paid the initial instalment of the purchase price of the Vessel. By Clause 4 that payment is, in effect, reversed, with the New Purchaser making a payment to the Builder of a amount equal to the instalment, and the Builder making a matching payment to the Original Purchaser.

133.In Clause 6 there is provision for the New Purchaser to require a further novation of the Shipbuilding Contract in favour of Northern LNG as the Replacement Purchaser (or in favour of an affiliate of Northern LNG).

134.By Clause 7 the Original Purchaser is, with the consent of the Builder, to be appointed by the New Purchaser as its agent to supervise the construction of the Vessel in accordance with the terms of the Shipbuilding Contract (there is a separate Supervision Agreement setting out the terms upon which that appointment is made).

The Lease Agreement

135.This is the finance lease of the Vessel between the Appellant as the "Lessor" and Northern LNG as the "Lessee". It runs to 286 pages (including the form of a Letter of Credit which comprises one of the Schedules). In its terms it is a conventional UK tax-based finance lease whereby (in broad terms), over the primary period the Lessor recovers, by way of the quarterly rentals it receives, its capital outlay on the purchase of the Vessel together with a variable finance charge so as to give it a specified return or margin over the primary period. The amount of those rentals is fixed at the outset by reference to a number of assumptions as to interest and other finance costs and as to the tax position of the Lessor with regard to the transaction (including its entitlement to claim 25 per cent writing-down allowances on the amount paid to acquire the Vessel) with provision to adjust the amount of the rentals should those assumptions prove not to be correct at any time, so that the Lessor's post-tax return is maintained. Under various ancillary documents, on the termination of the lease most of the value of the Vessel (after all amounts have been paid to make good the Lessor's investment and return) is rebated to the Lessee.

136.Clause 3 provides for the lease of the Vessel by the Lessor to the Lessee for the Primary Period and, if the Lessee so requests, the Secondary Period or successive Secondary Periods. The Primary Period commences on delivery of the Vessel and runs for thirty years. Provided it has complied with all the provisions of the lease and the ancillary documents, the Lessee has the right to require that the lease is extended for successive periods of twelve months after the end of the Primary Period.

137.By Clause 5 the Lessor covenants that it will not, by its own actions, interfere with the Lessee's use, possession and quiet enjoyment of the Vessel nor permit specified encumbrances on the Vessel to arise.

138.For the duration of the term of the lease, the benefits which the Lessor has under warranties and indemnities given to it as the purchaser of the Vessel under the shipbuilding contract are assigned to the Lessee: Clause 6.

139.By Clause 7 the Lessee agrees to pay rent to the Lessor during the Primary Period on quarterly rental dates. For the Secondary Period rent is paid annually.

140.The amount of each rental payment during the Primary Period is determined by the Financial Schedule to the Lease, which provides for a cashflow statement to be prepared taking account of the financial and tax variable assumptions and non-

variable principles set out in detail in the Financial Schedule, so as to produce the amount of rental required to maintain the agreed post-tax annual return for the Lessor from its investment in the Vessel and the lease. For the Secondary Period the annual rental is 0.1 per cent of the price paid for the Vessel.

141.Clause 12 provides that title to the Vessel remains at all times vested in the Lessor, with the Lesee's rights limited to the use of the Vessel as provided in the lease. The Lessor is to be, and remain, the registered owner of the Vessel. By Clauses 13 and 14 the Lessee is given the full and exclusive possession, control, command and use of the Vessel, subject to the terms and conditions of the lease. The Lessee is permitted to operate the Vessel in any part of the world in any lawful trade for which the Vessel is suitable. The Lessee gives wide-ranging undertakings to the Lessor to maintain and operate the Vessel to specified standards and in compliance with relevant regulations. The Lessee also undertakes not to use the Vessel for a purpose which is not a "qualifying purpose" within the capital allowances legislation.

142.By Clause 15 the Lessee is permitted to sub-lease the Vessel by the bareboat charter of the Vessel made between the Lessee and K-Euro, and it is permitted for K-Euro to take a novation of the time charter of 19 December 2001 in respect of the Vessel between K-Line and the Snøhvit Sellers. Any other sub-leasing must meet certain requirements and in any event requires the consent of the Lessor, and if the time charter is terminated, the Vessel must be let under a time or voyage charter which ensures that the Vessel is used for a "qualifying purpose" and is in other respects acceptable to the Lessor.

143.There are extensive provisions in Clause 16 requiring the Lessee at its own cost to insure the Vessel throughout the duration of the lease for specified risks (including hull, fire, marine and protection and indemnity risks). The Lessee's obligations in this respect are satisfied if K-Euro, as sub-lessee, undertakes such insurance obligations.

144.Clause 24 to 27 deal with early termination of the lease. The lease is terminated should a specified event of default occur (which includes any change in the shareholdings in the Lessee, unless the Lessor consents to such change), and there is also provision for voluntary termination, upon notice, by the Lessee. The Vessel is re-delivered to the Lessor, and provision is made for the sale of the Vessel and for a rebate of rental to the Lessee for an amount equal to the net proceeds of sale. A termination amount is payable by the Lessee to the Lessor, calculated by means of a termination cashflow statement prepared upon the terms specified in the Financial Schedule so as to repay the Lessor for its investment in the Vessel and to give it the agreed return.

145.Clause 22 relates to security provision, requiring the Lessee to procure an irrevocable standby Letter of Credit in favour of the Lessor in specified terms from a bank acceptable to the Lessor. The amount secured by such Letter of Credit (once the Primary Period has commenced) is the aggregate of the present values of the amounts of Primary Period rentals as derived from a cashflow statement prepared for the purpose. Should there be any change in the amount of rental payments during the Primary Period (because a variable assumption has proved to be incorrect), a further

cashflow statement is prepared to recalculate the amount required to be secured and a revised Letter of Credit must be procured. The initial Letter of Credit was issued by HBOS Treasury Services plc.

Guarantees

146.The shareholders of Northern LNG severally, and in proportion to their respective shareholdings, guarantee to the Appellant the due performance by Northern LNG its obligations to the Appellant under the head lease.

147.Lloyds TSB Bank plc guarantees to Northern LNG the due performance by the Appellant of its obligations to Northern LNG under the head lease.

The bareboat charter

148.The bareboat charter is between Northern LNG (as the "Lessee") and K-Euro (as the "Bareboat Charterer"). By Clause 3 Northern LNG agrees to bareboat charter the Vessel to K-Euro for an initial period of 20 years beginning with delivery of the Vessel and thereafter (at Northern LNG's option) for an extension period of 5 years and a further extension period (again, at Northern LNG's option) of 5 years. The bareboat charter and the rights of K-Euro as charterer are expressed to be subordinate to the rights of the Appellant as head lessor, so that the chartering of the Vessel terminates if the head lease terminates.

149.Northern LNG undertakes to K-Euro that it will not by its own action interfere with K-Euro's use and quiet enjoyment of the Vessel: no further warranty is given by Northern LNG in respect of the Vessel: Clause 5.

150.For the duration of the leasing Northern LNG assigns to K-Euro the warranty and indemnity rights which were in turn assigned to Northern LNG by the Appellant under the head lease: Clause 6.

151.The payment of rent is provided for in Clause 7 and the Rental Schedule. Rentals are paid monthly, and the amount paid is specified in the Rental Schedule for each month during the hire period up to the 144th month. The amount paid per month varies from US$1,130,000 to US$1,406,600. Rentals after the 145th month are to be agreed in the final six months, with the termination of the bareboat charter if no agreement is reached.

152.The Rental Schedule provides: "The Rentals have been determined on the basis of what [Northern LNG] and [K-Euro] consider at the date of this Agreement to be a commercial, fair market charter rate for the provision and operation of the Vessel on bareboat charter terms for its initial fixed period". It then provides that if at any time prior to delivery of the Vessel those rentals do not continue to represent such a rate, then they may seek to negotiate revised rentals to result in what is then a commercial and fair market charter rate for the Vessel. If no alternative rate is agreed, the original rentals remain payable.

153.By Clause 8 K-Euro agrees to pay all costs in relation to the Vessel and the operation of the Vessel (other than the rental and other costs to be borne by Northern LNG under the head lease and related documents).

154.In Clause 12 K-Euro confirms that title to the Vessel remains vested in the Appellant, and that K-Euro's sole interest in the Vessel is to use it upon the terms of the bareboat charter. K-Euro, at its expense, is to register (and maintain the registration of) the Vessel with the Appellant as the registered owner. K-Euro undertakes that it will do nothing to jeopardise the interests of the Appellant and Northern LNG in the Vessel.

155.K-Euro is entitled to the full and exclusive possession of the Vessel, which is to be at its absolute disposal and under its complete control and responsibility. K-Euro is required to maintain the Vessel in a good state of repair and in efficient operating condition and to dry-dock the Vessel for cleaning and painting in accordance with good industry practice. It must ensure that the Vessel is operated so as to comply with all applicable regulations, and not in a manner which might render the Vessel liable to requisition or seizure or in a manner which might imperil the Vessel's registration or classification. The Vessel may be operated by K-Euro in any lawful trade for which the Vessel is suitable, and all costs of operating, manning and provisioning the Vessel are for the account of K-Euro. The Vessel is not to be used by K-Euro for a purpose which is not a "qualifying purpose" within the capital allowances legislation.

156.The bareboat charter is subject to the time charter in favour of the Snøhvit Sellers. K-Euro cannot sub-let the Vessel on a bareboat or demise charter basis without Northern LNG's prior consent, and then only if the terms of such a charter comply with certain requirements: Clause 15.

157.K-Euro undertakes to comply with the insurance obligations specified in Clause 16 of the head lease (effectively taking over Northern LNG's obligations to maintain insurance in respect of the Vessel and its operation). Risk to the use of the Vessel is borne by K-Euro, and if there is a total loss of the Vessel the bareboat charter is terminated. More generally, the bareboat charter is terminated if a specified default occurs (which includes the termination of the head lease and also the termination of the time charter where it is not replaced with a time charter acceptable to Northern LNG). K-Euro may also voluntarily terminate the bareboat charter at any time upon notice. On termination K-Euro must re-deliver the Vessel to Northern LNG (unless the Vessel is a total loss). No termination sum is payable in respect of future rentals.

The time charter

158.The time charter party in respect of the Vessel was entered into on 19 December 2001 between K-Line ("Owners") and Statoil (on behalf of the Snøhvit Sellers). It is subject to English law. It comprises 68 clauses, several appendices, and five Addenda (the first three of which were also entered into on 19 December 2001). On 19 September 2002, as part of the lease financing arrangements, the time charter was novated on terms whereby K-Euro took the place of K-Line as "Owners". Such

novation was foreshadowed in Clause 65 of the time charter, which gives K-Line the rights to novate its rights and obligations under the time charter to any lender or lessee in connection with or for the purposes of any financing arrangements in relation to the Vessel. This is further bolstered by Addendum No 3, by which the Snøhvit Sellers consent in principle to the financing of the Vessel by the Owners by means of a UK lease, and to consequential changes in the documentation (including the novation of the time charter) to facilitate such financing, provided that the substantive position of the Snøhvit Sellers is not thereby adversely affected.

159. The time charter was the particular focus of a number of the submissions made by both the Appellant and the Commissioners: its terms are directly relevant to the determination of Issue 1 and are relevant also to the determination of Issues 2 and 4. It is necessary to set out in full certain of those terms, not least because the parties interpreted them quite differently in arguing their respective cases.

160. Clause 1 (together with Appendix 1) specifies the technical requirements which the Vessel must meet in order for it to carry LNG in international trade and the detailed specifications and performance standards which must be met. Clause 2 requires K-Euro (it is convenient to look to the parties as they were after the novation and as at delivery of the Vessel, when the time charter hire period began) to provide a full and efficient complement of master, officers and crew for the Vessel to the requisite standards and competence. K-Euro guarantees that, throughout the charter period, the master, officers and crew will prosecute all voyages and load and discharge cargo in accordance with the instructions given by the Snøhvit Sellers.

161. Clause 3 requires K-Euro to maintain the Vessel.

162. The hire period under the time charter is twenty years beginning on the date of delivery of the Vessel, with the Snøhvit Sellers having the option to extend the hire period for two successive five year extension periods. The Vessel is hired for the purpose of carrying LNG cargo in any part of the world at the direction of the Snøhvit Sellers. K-Euro is required to make the Vessel compatible, at the date of delivery, with ship/shore interfaces at specified LNG loading and discharging terminals. Modifications required to the Vessel to enable it to trade to other loading or discharging terminals are at the cost of the Snøhvit Sellers: Clause 4.

163. Clause 6 provides that K-Euro will provide and pay for all provisions, wages, shipping and other costs or expenses relating to the Vessel and its crew, including insurance, dry-docking, overhaul, maintenance and repairs. If the Snøhvit Sellers require the Vessel to trade in an area where there is war or the threat of war, any consequential costs or increased costs are to be borne by the Snøhvit Sellers.

164. The requirement in Clause 6 that K-Euro pays for insurance on the Vessel is amplified in Appendix II, which sets out in detail the types of insurance cover which is to be maintained during the charter period. It requires K-Euro to collaborate with the Snøhvit Sellers in all insurance matters, including the terms and extent of cover, deductibles, and premiums. Insurance requirements are to be reviewed at least every five years. The Snøhvit Sellers have the right to suggest changes to any insurance

arrangements suggested by K-Euro, and K-Euro must itself bear any additional costs it incurs if it does not follow any such suggested changes. The types of cover required are categorised as follows: hull and machinery insurance; protection and indemnity insurance and social responsibility insurance; and war risks insurance and loss of hire insurance.

165. K-Euro is responsible for the payment of all insurance premiums and calls. Under the heading "Reimbursement of Owner", it is provided that the insurances required by the time charter "are an item included in the Operating Element of Hire as described in Appendix II of Charter. Changes in net premiums for [such insurance] shall be dealt with as provided in Appendix II (Insurance cost category of the Operating Element of Hire)." (It would seem that the reference to Appendix II should be to Addendum No 1.) The provisions for the payment of hire and the calculation of the amount of hire are referred to in paragraphs 174 to 184 below.

166. The Snøhvit Sellers are required by Clause 7 to provide at their own expense or pay for all fuel to run the Vessel and bunker oil (but not for fuel used in, or in preparation for, dry-docking or repairing the Vessel); towage, tugboat and pilotage expenses; port charges; expenses of loading and unloading cargoes (including the employment of stevedores); and canal and similar dues. Such expenses are for K-Euro's account while the Vessel is off-hire, and K-Euro bears the cost of fuel used in connection with the preparation for and the dry-docking or repair of the Vessel.

167. The time charter rate and payment of hire provisions are set out in Clauses 8 and 9 and Addendum No 1, and are dealt with below. Clause 21 details the circumstances in which the Vessel is to be regarded as off-hire, and hire is not payable in relation to off-hire periods (but such periods count as part of the Charter period). Hire ceases to be payable on the loss of the Vessel.

168. Although the master and crew of the Vessel are provided at K-Euro's cost, the Snøhvit Sellers instruct the master as to voyage and sailing directions, and he is under their direction as regards employment of the Vessel and as to signing bills of lading.

169. The Vessel is to be loaded and discharged at any port or dock specified by the Snøhvit Sellers, who are not liable for any loss or damage resulting from conditions at the specified port or dock unless such loss results from their fault or neglect. These provisions are subject to the requirement for the Snøhvit Sellers to ensure that terminal facilities in specified ports are compatible with the Vessel.

170. The Snøhvit Sellers may sub-charter the Vessel so long as they continue to remain liable to K-Euro under the time charter.

171. There is provision in Clause 22 for dry-docking and maintenance of the Vessel at specified intervals, and for unscheduled dry-docking, with consultation between the parties as to timing and the selection of the dry-dock port. K-Euro is required to review with the Snøhvit Sellers the proposed specification for each dry-docking (including the estimated costs), and to obtain their consent to such specification and

costs. During the period of dry-docking, and including deviation time, the Vessel is off-hire.

172. K-Euro gives undertakings as to the cargo capacity of the Vessel, the speed and fuel consumption of the Vessel, and its capability to transfer its cargo within specified parameters.

173. There are extensive provisions requiring compliance with international regulations and collision rules applicable to the Vessel and the carrying of LNG.

The time charter hire payment provisions

174. The time charter hire payment provisions require special consideration in view of the respective arguments of the parties in this case. By common consent of the parties (the Appellant's witnesses, too) the drafting of certain aspects of the provisions relating to the adjustment of the hire payment is unclear.

175. Clause 8 provides that "as full compensation for the performance by [K-Euro] of [its] obligations under this Charter, hire shall accrue in accordance with Addendum No 1 appended hereto….". Clause 9 provides for the payment of hire in US dollars per calendar month in advance.

176. Addendum No 1 first provides that "Hire payable under this Charter shall consist of a Capital Element and an Operating Cost Element each of which shall be determined in accordance with this Addendum No 1".

177. The Capital Element of hire is then defined. It is a fixed US dollar amount based on the shipyard price of the Vessels and related Depot Spares. For the initial 20 year charter period the amount is US$52,491 per day, and for any extension period, US$25,000 per day. One-off adjustments by reference to a formula are made to those amounts before the charter period begins on delivery of the Vessel if the actual price paid for the Depot Spare Parts under the Shipbuilding Contract is increased by reason of modifications to the Vessel. The fixed amounts are predicated on a 20-year interest rate of 6.5 per cent, and a further one-off adjustment is made if the actual 20-year interest rate as at the execution of the time charter differs from that assumed rate.

178. The Operating Cost Element of hire is comprised of three categories: Fixed Operating Cost; Pass-Through Operating Cost; and Non-auditable Expenses.

179. The category of Fixed Operating Cost covers: "Manning; Maintenance and Repair, including consumables but excluding Dry-docking; and Dry-docking." The Addendum provides for an annual escalation and five-yearly review of Fixed Operating Cost in these terms:

> "For the first five years of the initial Charter period the Fixed Operating Costs shall be escalated at an annual escalation rate of 2.5%. For the subsequent five years period (and each subsequent five years period thereafter) the applicable rate shall be reviewed and agreed

taking into account the actual costs incurred during the previous five years period, the Vessel's age and trades."

180. The category of Pass-Through Cost covers: "all premiums of Hull and Machinery (including War Risks) Insurance; Loss of Hire (including War Risks) Insurance; Protection and Indemnity Insurance; and Social Responsibility Insurance." There is no provision for escalation of such costs.

181. The category of Non-auditable Expenses covers: "[K-Euro's] administration costs in Europe and the headquarters including but not limited to salaries of office staff, security, office rental and travelling expenses for services rendered with respect to the management of operation of the [Vessel]. For the initial Charter period the Non-Auditable Expenses shall be escalated at an annual escalation rate of 2.5%."

182. Having defined the Operating Cost Element and its component parts in this way, there is then a table setting out "for the purposes of this Schedule, the Vessels' initial five-year operating costs for each category specified … (in 2006 values)." The table is as follows:

(Daily costs in USD)

	Year 1	Year 2	Year 3	Year 4	Year 5
(1) Fixed Operating Element					
Manning	4,260	4,370	4,860	4,590	5,110
Maintenance incl consumables	820	730	1,390	1,000	1,650
Dry-dockings			6,340		9,390
Sub-total	*5,080*	*5,100*	*12,590*	*5,590*	*16,150*
(2) Pass through Operating (estimated) Insurance					
Hull+ Machinery (inc War Risk)	680	650	670	580	600
Loss of Hire (inc War Risk)	180	180	210	180	210
P & I (inc Supplemental Calls)	160	160	170	160	170
Social Responsibility	220	220	240	220	240
Sub-total	*1,240*	*1,210*	*1,290*	*1,140*	*1,220*
(3) Non-auditable Management Fee	2,240	2,290	2,500	2,380	2,600
Total Operating Costs Element	**8,560**	**8,600**	**16,380**	**9,110**	**19,970**

The Operating Cost elements shown above in the table has been adjusted for 2.5% per annual escalation where applicable.

183. The Addendum then continues in these terms:

> [K-Euro] and the [Snøhvit Sellers] shall meet at a mutually agreed time at least ninety (90) days prior to the Delivery Date for the purpose of establishing estimated operating costs for the period from the Delivery Date to December 31 of the same year as that in which the Delivery Date falls. Thereafter, at least sixty (60) days prior to January 1 of each calendar year during the Charter Period, [K-Euro] and the [Snøhvit Sellers] shall meet for the purposes of establishing such estimated costs with respect to that year.
>
> No later than ninety (90) days before scheduled dry-docking and maintenance is due to take place pursuant to Clause 15 of the Charter, K-Euro shall provide the [Snøhvit Sellers] with a budget estimate and breakdown of the costs of dry-docking."

184. As to "Pass through Operating Insurance" hire, the amounts of insurance costs paid by K-Euro in 2006 were US$495,000; in 2007, US$662,000; in 2008, US$762,000; and in 2009, also US$762,000. These amounts, expressed as a percentage of the total costs paid by K-Euro for the operation of the Vessels (disregarding the amount of hire paid under the bareboat charter) are: in 2006, 8.91 per cent; in 2007, 8.04 per cent; in 2008, 7.725 per cent; and in 2009, 6.72 per cent.

The time charter novation agreement

185. For the sake of completeness we note that in March 2002 there was a novation of the time charter from Statoil (which in the time charter was expressed to be acting on behalf of the Snøhvit Sellers) to all the Snøhvit Sellers as named parties.

186. The time charter novation agreement with which we are concerned was, as we have already mentioned, entered into on 19 September 2002 as part of the lease financing transactions. It is the means whereby the chain of leasing is completed, from the owner of the Vessel (that is, the Appellant) to the users of the Vessel (the Snøhvit Sellers).

187. The parties to the agreement are K-Line (the "Original Owner"); the Snøhvit Sellers (the "Charterers"); and K-Euro (the "New Owner"). It recites that K-Euro has agreed to assume as disponent owner all the rights and obligations of K-Line under the time charter, and that the Snøhvit Sellers have agreed to the substitution of K-Euro in place of K-Line in relation to the time charter.

188. The novation is effected by Clause 3. K-Line novates the time charter to K-Euro, with the consent of the Snøhvit Sellers, on and with effect from 19 September 2002. K-Line releases the Snøhvit Sellers from their obligations to K-Line under the time charter and the Snøhvit Sellers undertake to perform those obligations in favour of K-Euro; the Snøhvit Sellers release K-Line from its obligations to the Snøhvit Sellers under the time charter, and K-Euro undertakes to assume and perform those obligations in substitution for K-Line; K-Euro has the benefit of the rights under the time charter previously enuring to K-Line.

189. Various minor amendments are made to the terms of the time charter by Clause 4, and by Clause 5 K-Line agrees to give to the Snøhvit Sellers a guarantee (in

prescribed form) of K-Euro's due performance of its obligations under the time charter.

The Ship Management Agreement

190.Following the reorganisation of K-Euro's business in 2006, although K-Euro continued to lease the Vessel under the bareboat charter and to charter it to the Snøhvit Sellers by the time charter, it contracted out the management of the Vessel to its associated company, K-LNG.

191.The Ship Management Agreement is dated 9 February 2006 and is between K-Euro (now named Polar LNG Shipping (UK) Ltd, and identified in the agreement as the "Owner") and K-LNG (the "Manager"). It runs for one year from 15 February 2006 and thereafter until terminated by three months' notice by either party. The agreement is a standard Baltic and International Marine Council ship management agreement. It identifies the following as the management services which K-LNG will supply to K-Euro: crew management; technical management; insurance arrangements; accounting services; and provisioning the Vessel. Commercial management, (specifically, the sale or purchase of the Vessel, bunkering, and chartering services) is specifically excluded from the management services which K-LNG is to supply.

192.Clause 2 appoints K-LNG as manager of the Vessel, and by Clauses 3 and 4 K-LNG agrees to carry out the management services in respect of the Vessel "as agent for and on behalf of [K-Euro]". By Clauses 5 and 8 K-Euro pays monthly in advance a daily management fee of US$2,240 by way of remuneration of K-LNG for acting as manager.

Further findings of fact

193.From the documents in evidence, and from the evidence of the witnesses, we make further findings of fact as set out in paragraphs 194 to 257 following. They are to be read in conjunction with the Statement of Agreed Facts set out at paragraphs 50 to 102 above.

The LNG market and the Snøhvit Project

194.The shipment of natural gas in liquefied form is a modern, highly-technical and highly-specialised business. Natural gas is more commonly transported from production field and terminal storage to the consumer market by pipeline across land or under the sea, but where undersea pipelines are not feasible, the gas can be liquefied by a freezing process and transported in that form in purpose-built ships to a destination port terminal, where the liquefying process is reversed and the gas can proceed by pipeline to the consumer market.

195.A feature of the LNG market is that suppliers enter into long-term supply contracts with their customers. In October 2001 the Snøhvit Sellers entered into such long-term natural gas supply contracts with two customers, El Paso Global LNG (for

shipment to the US east coast) and Iberdrola SA (for shipment to Spain). These contracts were expected to run for between 17 and 20 years.

196. An LNG carrier or tanker performs essentially as a pipeline providing the infrastructure required to carry out the long-term customer supply contracts entered into by the producer energy companies. It is therefore usual to have vessels built to service particular gas production facilities and such long-term contracts. By means of ownership or long-term charter arrangements such vessels will effectively be dedicated to such service. There is little by way of a short-term or "spot" shipping market for LNG (unlike that for, say, bulk cargoes).

197. The producer companies will want to ensure the reliability and safety of the supply over the years to their customers and the maintenance of the high and specialist technical standards required to ship this particular cargo. To that end the producer companies will require control over the design and specification of the carrier ships and over their operation.

198. The Snøhvit Sellers had such objectives, and in order to obtain necessary government consents to the development of the Snøhvit project they had to demonstrate that they could secure long-term supply contracts and could meet the requirements of those contracts in terms of the regular, long-term and reliable shipment of LNG. The Snøhvit Sellers (other than Statoil) did not themselves have experience of owning or operating ships, nor did they (including Statoil) have the specialist expertise required to operate LNG carriers.

The tender process

199. The tender process was designed to find shipyards to build the carriers which the Snøhvit Sellers required to supply LNG to their long-term customers and to find a shipping company which would purchase and own those carriers and lease them to the Snøhvit Sellers on terms whereby the operation and management of the carriers would be carried out by the shipping company. The two-fold tender process, and the principal commercial terms which formed the arrangements which resulted from that process, were devised by Statoil, under the leadership of Mr Thomassen. As might be expected for such a specialised, technical and commercially substantial venture conducted to the highest standards, the tender and bidding process, as to both shipyards and shipping owners, was lengthy and complex. The main features of the process were as follows:

(1) The tender process began in January 2001, and by March 2001 six shipyards were short-listed (including those which eventually built the Vessels);

(2) After an initial evaluation process eleven shipowners/operators were invited to submit tenders in April 2001. The outline terms of the 20 year time charter were specified by Statoil, including a rent to be calculated using a Capital Element and an Operating Cost Element (the actual rate of hire was negotiated as part of the tender process, and having regard to the cost of the Vessels, likely finance costs, and the shipowner's estimate of operating costs);

(3) The bids from the shipowners were evaluated against the commercial and technical requirements of the Snøhvit Sellers. K-Line and four other shipowners were shortlisted, and there was a re-bidding process in June 2001. After further re-bids and evaluations in July 2001 K-Line's bid was accepted, subject to Norwegian government consent for the project (which was finally forthcoming in May 2002). K-Line also met a further preference of the Søhvit Sellers, in that it had experience of operating LNG vessels, and thus had performed to the special technical and safety standards required in operating such vessels;

(4) All Statoil's principal dealings with K-Line were with K-Line personnel based in Tokyo;

(5) From as early as July 2001 Statoil had reserved the option for one or more of the Snøhvit Sellers to take an equity interest in the economic ownership of the Vessels and K-Line had reserved its right to bring in co-owners, as it did not wish to have the Vessels and their financing on its balance sheet;

(6) Statoil and K-Line proceeded to document their agreement, conditionally on the consent of the Norwegian government, on 19 December 2001, and on that date also K-Line entered into the shipbuilding contracts for the Vessels with the chosen shipyards.

200. Part of the documentation entered into between Statoil and K-Line on 19 December 2001 was a Memorandum of Understanding setting out the further steps envisaged in connection with the provision of the Vessels. This document records the intention of the parties to finance the Vessels by way of a finance lease in the UK by means of a structure largely corresponding to that eventually adopted in September 2002, with K-Line novating the time charter to a company incorporated and carrying on business as ship operator in the UK which, as disponent owner holding its interest by means of the bareboat charter, would be responsible for the commercial and technical management of the Vessels. There is provision for the parties to arrange other financing if a UK lease is found not to be economically or legally viable. It also records that Statoil will, if such arrangements are implemented, have a minority shareholding interest in the special purpose companies which respectively have the reversionary equity interest in the Vessels (subsequently, Northern LNG).

201. It was an essential requirement of the Snøhvit Sellers that all aspects of the management of the Vessels (technical and commercial) should be carried out from a base in a European time zone: this requirement was in consequence of previous experience of Statoil where loss had been incurred because the operator/manager of a vessel delayed responding to a problem because of time zone differences.

202. Further, based on its experience with shuttle tankers in the North Sea, Statoil included a requirement that the shipowner should also be the operator of the ship, so that there would be a sense of responsibility for the ship as an asset, its operation and its performance. It was not acceptable that the counterparty should simply be a manager of a ship.

203. The K-Line bid was attractive to the Snøhvit Sellers not simply by reason of its commercial terms, but because K-Line met the requirements that it could, within its

group, both own and operate the Vessels and ensure that the Vessels were operated and managed in a European time zone. As early in the tender process as February 2001 K-Line had stated to Statoil that, in view of the proposed operation of the Vessels in the Atlantic Basin, the "management office for Snøhvit LNG Project is intended to be located in [K-Euro], a subsidiary established in London. Representatives in the [K-Euro] office will act as an interface between Charterers and K-Line Head Office". Statoil's principal concern was for the efficient, reliable and safe operation of the Vessels by a competent entity within the European time zone. The structure by which K-Line achieved that was not of particular interest to Statoil.

K-Line and its business strategy

204.K-Line is one of Japan's largest shipping companies. It has a substantial presence in the LNG shipping market: by the end of 2010 its LNG carrier fleet comprised 46 vessels out of a world fleet of approximately 360 vessels. Prior to its involvement in the Snøhvit project its involvement in the LNG market was confined to the East of Suez sector (principally shipping LNG to the Japan market).

205.From at least 2000 the published group strategy of K-Line was to diversify its business hubs so as to keep up with globally expanding markets and to give greater autonomy to overseas subsidiaries with shipping operations. This enabled it to provide its shipping services to customers from bases local to those customers.

206.In its group management plan of May 2002 K-Line stated that a fundamental part of its management plan was "the enhancement of those aspects of globalisation that are firmly based on regional communities"; it also referred to its intention to "set up a business stronghold of tramper and LNG-carrier business in Europe, putting [K-Euro], based in London, as the centerpiece in an attempt to secure new business"; it also referred to the need for new penetration of energy transport markets in Europe and the US, and to the development of certain regional "business strongholds", including K-Euro, with the shift of management and jobs from head office to such business strongholds.

207.Minutes of a board meeting of K-Line on 27 May 2002 refer to the establishment of a European base for the group's Bulk and Gas Division in pursuance of the group business plan. The minute notes the expected growth in the market for transporting bulk and energy resources, and the need to establish a business base in Europe in order fully to participate in the European sector of that market by operating in close contact with customers. The minute states: "In addition, as the UK moves to introduce new leasing systems, this will help to establish our status as a bona fide shipping company, enabling us to participate in shipping management and transport, including LNG vessels." The minute records the decision to establish a bulk and gas division in K-Euro as from 1 July 2002, Phase 1 of which will require a staff of three (two sent from head office and one recruited locally), with further staffing for subsequent phases as shipping capacity is added in relation to transport of bulk cargoes and LNG cargo (including the Snøhvit Project vessels). The directors of K-Euro correspondingly resolved, on 31 May 2002, to establish a Bulk and Gas Division.

208.K-Line saw a commercial advantage in expanding its LNG carrier business into the Atlantic Basin in view of the anticipated growth of business in that sector with increasing importation of LNG by the USA. It saw participation in the Snøhvit project as attractive because of the political stability of Norway (compared with other producer countries) and because it would give K-Line the competitive advantage of participating in the first major LNG carrier venture within the Atlantic Basin.

The development of K-Euro's business

209.K-Line's first UK subsidiary was established in 1927. Its business included chartering tramp ships and acting as a representative for K-Line. The business was closed down but since 1956 K-Line has had a UK subsidiary which acted as a representative for K-Line in respect of a range of shipping activities.

210.K-Euro was incorporated in 1987, and at that time its business encompassed acting as K-Line's general agent in Europe, operating both a UK agency and a general agency. The UK agency was focused on the container business, with commissions earned from dealing with the arrival and dispatch of shipments, and fees were also earned for organising the transfer of shipments from intercontinental ships to feeder vessels. The general agency business provided, on a fixed fee basis, administrative and marketing services to K-Line in relation to its container services and its car carrier business. In 1995 K-Euro began to operate, on its own account, a European coastal container service, chartering for the purpose four container ships by 2001, with K-Euro responsible for the commercial management of the vessels.

211.The audited report and financial statements of K-Euro for the year ended 31 December 2001 show that the principal activity of the company is "that of general shipping agents and shortsea container ship operators throughout Europe." Those accounts show a turnover for that year of £30.327m, a gross profit of £7.292m, and (after administrative expenses, interest and tax) a loss of £0.417m. In the balance sheet shareholders' funds are £0.149m. The average weekly number of employees during the year is shown as 124.

212.As mentioned, in May 2002 the board of K-Euro resolved to establish a bulk and gas carrier division, and to that end a three-stage business plan was agreed in July 2002. Phase 1 of the business plan as it related to the gas business was to seek customers, projects and business in Europe and the Atlantic Basin and to act as the point of contact with Statoil in respect of the Snøhvit Project; Phase 2 was to intensify and increase the Phase 1 activities; and Phase 3 was to continue the expansion of the business and to gear up for the delivery and operation of the Vessels. Each Phase required an increase in appropriate staffing. The business plan for the bulk business similarly planned, on a phased basis, for the development of a bulk carrier business in Europe and the Atlantic Basin.

213.A review of the business plan in January 2004 shows that at that time K-Euro had a management agreement for the LNG carrier "Al Thakhira" (of which K-Line is a member of the consortium owner) which transports LNG from the Ras Gas II Project in Qatar to Italy; was engaged in a tender process for selection of a crew management

company; was recruiting local LNG personnel to increase its technical team to five people and had increased the senior management and technical teams by secondments from K-Line and by local recruitment; had engaged in significant marketing activity with the aim of increasing the number of vessels in which it was involved; and was engaged in a tender process for a coastal LNG vessel.

214.From the time K-Euro decided to establish its bulk and gas division until the end of 2005 it took on secondment from K-Line eight senior management and technical staff for the purpose of developing the bulk and gas business, in addition to local recruitment. It used the services of a recruitment consultant to assist with recruiting marine and technical superintendents.

215.With regard to the vessels which it chartered or managed in the course of developing its bulk and gas division, K-Euro's business developed as follows:

(1) In September 2002 it participated in the Snøhvit Project by taking a grant of bareboat charters of the Vessels and a novation of the time charters to the Snøhvit Sellers (the Vessels were not delivered until 2006, after the reorganisation of K-Euro's business);

(2) In April 2003 it entered into time charter arrangements for two bulk carriers (both large vessels, one capesize, the other panamax), undertaking the commercial operation of the vessels;

(3) In 2004 it negotiated the contracts for the building of two capesize bulk carriers which it was intending to own and manage (both vessels were delivered after K-Euro reorganised its business in 2006);

(4) In January 2005 it took delivery of a new build capesize bulk carrier, which it owned and which it commercially managed;

(5) In July 2005 it entered into time charter arrangements in respect of a further capesize bulk carrier and a further panamax bulk carrier;

(6) In November 2005 it entered into time charter arrangements for a further new build capesize bulk carrier; and

(7) In November 2005 it commenced management of the LNG carrier "Al Thakhira".

216.The audited report and financial statements of K-Euro for the year ended 31 December 2005 state: "The principal activity of the company during the year was that of general shipping agents for containerships and car carriers throughout Europe as well as the operation of bulk vessels and ship management of LNG vessels throughout the world. The company's bulk division had eight bulk vessels in its fleet as at the end of the year." The turnover for the year is £42.633m, and gross profit is £18.854m. Profit after administrative expenses, interest and tax is £3.657m. The balance sheet shows equity shareholders' funds of £5.889m. The monthly average number of employees during the year was 163.

217.Following the reorganisation of the K-Euro business with effect from 1 January 2006 the component parts of that business are now operated by successor UK

companies. By the end of 2010 the successor company carrying on the bulk business was operating 18 bulk carrier vessels on a long-term basis (five of which are owned by that company), and the business had a turnover of US$183m and a staff of 18 employees. As of March 2011 the successor company carrying on the LNG carrier business (apart from the charter arrangements retained by K-Euro in respect of the Vessels) operates eight LNG vessels (either as disponent owner or under a ship management agreement, and including the Vessels, which that company manages for K-Euro) and the business (for the year to 31 December 2009) had a turnover of US$52.181m and a staff of 21. In the case of the LNG vessel for which K-LNG is the disponent owner, the vessel is owned through a UK finance lease structure.

The lease financing of the Vessels

218.Once K-Line was engaged in the tender process arranged by Statoil in 2001 it sought advice from a number of financial institutions as to the ways in which it might finance the purchase of the Vessels. Apart from other considerations, K-Line needed to have a good sense of possible financing costs in order to include, in its bid in the tender, a Capital Element within the hire rental in the proposed time charter to the Snøhvit Sellers. Consideration was given to debt financing, securitising ship rentals, and a variety of lease financing structures based in different jurisdictions.

219.In September 2001 K-Line mandated a leasing arranger, New Boston Partners (a subsidiary company of a major Japanese bank), to arrange the financing of the Vessels. The London firm of solicitors, Watson Farley Williams, was engaged to provide legal advice.

220.K-Line was advised of the benefits of a UK finance lease where capital allowances are available to the lessor. There was also discussion of the availability of the tonnage tax rules. K-Line had no previous experience of UK finance leases and relied on its advisers as to the requirements which must be met if a UK finance lease lessor is to claim allowances, and the basis on which those allowances are reflected in the finance lease provisions and financing terms.

221.Both New Boston Partners and Watson Farley Williams advised in the course of autumn 2001 that a "bona fide UK shipping company" was required to operate the Vessels if the "qualifying purpose" conditions were to be met. They advised that such a company should, if possible, be a company owned by K-Line or by the joint venture partners having the economic ownership of the Vessels (i.e. the shareholders of Northern LNG). They advised that it would be necessary for the ship operator to be in place as from delivery of the Vessels, and that it should be a ship operator and not merely a manager of the Vessels. They also advised that it would be helpful if the ship operator had a trading history and could demonstrate that the operation of the Vessels was an extension of its existing trading activities. This advice was specifically given with reference to the terms of section 123 CAA 2001, including section 123(4) CAA 2001.

222.In the early stages of the tender process K-Line had indicated to the Snøhvit Sellers that K-Euro would have a role in the management of the Vessels (to meet the

requirement of the Snøhvit Sellers that the Vessels should be managed from a base in a European time zone). In those early stages the exact way in which K-Euro would carry out that role was not decided upon. From the discussions between K-Line and its advisers K-Line was aware that for capital allowances to be available it was necessary that K-Euro should operate (and not merely manage) the Vessels in the UK finance lease structure.

223. In the course of email exchanges between K-Line and its UK advisers in relation to these matters and the role of K-Euro, K-Line sought advice as to the "proper profit level" of K-Euro if it were to act as ship operator, and whether there was any UK tax requirement in this respect – a concern which K-Line had was that, given the limited LNG carrier market, there was little by way of example to judge levels of profitability for a ship operator (as against a ship manager). Based on that advice, it was anticipated that K-Euro would make a profit margin of about 10 per cent of the Operating Cost Element of the hire received under the time charter.

224. K-Line also sought advice as to whether the establishment of a bulk and gas division by K-Euro would result in K-Euro being a ship operator for the purposes of the UK capital allowances legislation, and, in that context, whether there was a critical timescale in which that division had to be established.

225. K-Line was also advised as to the risks which K-Euro should bear for it to comprise a ship operator which would satisfy the requirements of the UK capital allowances provisions, and that the costs flowing from such risks should they materialise could ultimately and indirectly be borne by the shareholders of K-Euro (including the Snøhvit Sponsors should they become such shareholders) by reason of their respective shareholdings.

226. At this time K-Line also considered entering into a joint venture with a third party ship management company with experience in managing LNG carriers, in order to establish a ship operator in the UK, using the expertise and business of the joint venture party to establish rapidly a full service shipping company with LNG expertise. That idea was rejected by K-Line on the grounds that it did not fit with K-Line's strategy for growth of the Bulk and Gas businesses at local level within the K-Line group and that it might not be acceptable to Statoil. K-Line recognised that it would be necessary to grow K-Euro's business organically so that it could function as a ship operator.

227. As mentioned, the documentation entered into between K-Line and the Snøhvit Sellers on 19 December 2001 anticipates that K-Line might wish to arrange financing of the Vessels in the form of a UK finance lease, and the leasing structure which that would likely require, including K-Euro as the disponent owner of the Vessels.

228. In January 2002 prospective UK lessor banks were approached, including the Lloyds TSB group. They were advised of the shipbuilding and time charter arrangements in place and of the leasing structure which was proposed should the financing of the Vessels be effected by a UK finance lease. Prospective lessors were

informed that the Vessels would be used for a "qualifying purpose" by reason of K-Euro, as ship operator, satisfying the requirements of section 123 CAA 2001.

229.On 16 April 2002 Lloyds TSB Leasing Ltd entered into heads of terms with K-Line and the other Snøhvit Sponsors and with Northern LNG setting out the terms under which it was prepared to offer a UK lease facility in respect of the financing of the Vessels, subject to negotiation of satisfactory documentation.

230.Negotiations were completed in September 2002 (by which time parliamentary consent had been obtained in Norway for the Snøhvit project), and the lease documents, as set out above, were entered into on 19 September 2002.

K-Euro's participation in the lease structure

231.All discussions as to the structuring of the lease financing, and the negotiation of the lease financing itself, were undertaken by K-Line. Similarly, the proposals for establishing a bulk and gas division to operate within the Atlantic Basin as part of the business of K-Euro were initiated by K-Line.

232.K-Euro was involved in the discussions concerning the Snøhvit project and the possible UK finance lease financing of the Vessels in the autumn of 2001, and in November 2001 a director of K-Euro expressed the view that at that time K-Euro had no intention either to own any LNG vessel or to charter such a vessel on bareboat terms. At that time, although K-Euro had experience of operating container vessels, it had no experience of operating or managing LNG carriers, and would not have been credible to the Snøhvit Sellers as operator of the Vessels. K-Euro had to be persuaded by K-Line that it should expand its business so that it would be in a position to act as operator of the Vessels on their delivery.

233.At a board meeting of K-Euro on 22 February 2002 there was discussion of the plan to expand K-Euro's business by the establishment of bulk and LNG carrier divisions for operation in Europe, with the intention that K-Euro would operate and manage the vessels employed in those divisions. That meeting also reviewed the shipbuilding contracts and the time charters in respect of the Vessels entered into on 19 December 2001 and the proposed finance leasing arrangements were also discussed, including K-Euro's intended part in those proposals. It was noted that if the proposals were implemented with K-Euro's participation, K-Euro would be disponent owner of the Vessels, having responsibility for the commercial and technical management of the Vessels but without the economic risks of ownership. It was also noted that if K-Euro operated the Vessels its aim would be to earn an operator's profit, and that the question of K-Euro's profit margin had not yet been agreed. It was agreed that one of the directors would continue to review the proposals on K-Euro's behalf and to negotiate any documents involving K-Euro, with that director reporting back informally to the remaining directors.

234.Directors of K-Euro (including the chief executive officer) were subsequently involved in discussions as to the basis on which K-Euro would act as disponent owner, and in particular as to the rate of hire under the proposed bareboat charter (the

terms of the time charter having been agreed in the December 2001 transaction, the amount of the bareboat hire was a critical factor in determining the likely profitability of the venture for K-Euro).

235. At a board meeting of K-Euro on 12 September 2002 the directors were presented with the terms of the lease financing of the Vessels and with the documents to which it was proposed that K-Euro should become a party. It was noted that K-Euro would become responsible for operating and managing the Vessels as disponent owner, assuming obligations under the bareboat charter and having responsibility for the commercial and technical management of the Vessels. It was also noted that K-Euro could expect to make a profit from such operation.

236. At that board meeting there was also produced to the directors a copy of the business plan, dated July 2002, for the bulk and gas division of K-Euro. It was noted that that division had been established on 1 July 2002 (following a board resolution to that effect on 31 May 2002) in order for K-Euro actively to develop its bulk and LNG carrier business in Europe by establishing bulk and LNG fleets. It was also noted that the proposals whereby K-Euro became disponent owner of the Vessels were in furtherance of the business plan. Resolutions were passed approving the bulk and gas division business plan and authorising K-Euro to enter into the relevant documents by way of implementation of the lease financing arrangements.

237. As disponent owner of the Vessels K-Euro is exposed to the commercial risks which flow from its operating, crewing and maintenance responsibilities under the time charter and from any deficit which may arise should the costs of carrying out those responsibilities, together with the bareboat hire, exceed the hire paid under the time charter. It was anticipated when K-Euro entered into the bareboat charter and time charter arrangements that K-Euro's profit would equate to the non-audited management fee element in the time charter hire payment and a margin above operating costs which was expected to be approximately 10 per cent of such costs, but it became clear before delivery that actual operating costs would be significantly higher than anticipated, and that a sizeable loss would accrue without remedial action. K-Euro is also exposed commercially to the extent that any obligations placed on it under the bareboat charter are not off-set by countervailing rights it has under the time charter. K-Euro also bears the risk of costs (without receipt of hire) for any off-hire periods, (except for days 7 to 187 of any such periods, for which it takes insurance cover).

238. The preferred business model of the K-Line group is that where K-Line owns or part-owns a vessel, then a member of the group should act as disponent owner time chartering the vessel: this ensures that the commercial advantage is retained of having the direct and operational relationship with the customer. But where a vessel is owned by a consortium of shipping companies (which is common in the case of LNG vessels, so that no one shipping company has the vessel, or its financing, on its balance sheet) the consortium company will grant the time charter and will contract out the management of the vessel to a third party manager: this ensures that no one consortium member has, to the possible detriment of the others, the commercial advantage of the operational relationship with the charterer customer.

239. Although the Vessels are, through Northern LNG, owned (economically) by a consortium, only one other consortium member, Iino Kaiun Kaisha, Ltd, is a shipping company. It, however, has no other LNG interests: therefore K-Line was able, in relation to the Vessels, to apply its preferred model, with a group member (in this case K-Euro) operating the Vessels. This has not generally been the case in relation to other LNG vessels in which the K-Line group has an interest. K-Euro has not acted as disponent owner of any other LNG vessels. K-LNG (the successor, since 2006, to K-Euro's LNG carrier business) is, however, the disponent owner of an LNG vessel of which it took delivery in 2007: that is a vessel in which the K-Line group has a full ownership interest through a UK finance lease. Different considerations apply to the ownership and operation of bulk carriers, and K-Euro (and the successor to its bulk carrier business, K-Bulk) has entered into time charter arrangements for most of its bulk carrier fleet.

The 2006 reorganisation of K-Euro's business and share capital

240. With effect from 1 January 2006 K-Euro reorganised its business at the direction of K-Line. In summary, K-Euro retained only the bareboat and time charters in respect of the Vessels, and all other parts of its business were transferred to newly-formed UK subsidiary companies of K-Line (see paragraph 97 above).

241. Further, since the personnel, expertise and other operative parts of the LNG business had been transferred to K-LNG, K-Euro contracted with K-LNG by means of a ship management contract for that company to carry out all the ship management functions in respect of the Vessels. K-Euro remains liable to the Snøhvit Sellers, as time charterers, for the operation of the Vessels as required by the terms of the time charter, and liable to Northern LNG to perform the obligations imposed by the bareboat charter.

242. In a related transaction, in October 2006 the share capital of K-Euro was reorganised, with the result that each of the Snøhvit Sponsors held a proportionate share of the K-Euro share capital corresponding to their respective proportionate shares in the share capital of Northern LNG I and Northern LNG II respectively. In the course of that share capital reorganisation additional share capital was subscribed to K-Euro.

243. The principal reason for the reorganisation was to deal with anticipated losses in K-Euro in respect of the operation of the Vessels; it had two further benefits in that it enabled the bulk business to be brought within the UK tonnage tax regime; and it freed the future development of the business from restraints imposed under the UK finance lease documentation.

244. The hire for the Vessels which K-Euro receives under the time charter is fixed, subject to an escalation factor for certain parts of the Operating Cost Element of the hire. There is a review mechanism at the end of each five-year period. Correspondingly, the hire it pays under the bareboat charter is fixed (at least for 12 years). Its operating costs of crewing, maintaining, provisioning and repairing the Vessels are not fixed costs: they are subject to market conditions. To the extent that

they are not recovered out of the Operating Cost Element of the time charter hire K-Euro suffers a loss in relation to this part of its business.

245.In the years following 2002 there was a significant increase in the number of LNG carriers world-wide, and a consequent shortage of the specialist crew required for such vessels. Crewing costs increased rapidly, outside the expected trend. Exchange rate movements exacerbated the shortfall where (as in the case of K-Euro) hire was received in one currency (US dollars) and a significant portion of the crewing costs were payable in "stronger" currencies (such as the Norwegian Krone).

246.It became apparent to K-Euro, and to K-Line and the other Snøhvit Sponsors, well in advance of delivery of the Vessels, that K-Euro would, following delivery, be operating the Vessels at a significant loss. The Snøhvit Sellers had agreed their deal in terms of the time charter hire, and were not minded to renegotiate that deal.

247.In January 2003 K-Line wrote to the other Snøhvit Sponsors setting out its views that the original understanding was that the risk of losses from operational expenditure in running the Vessels would be shared by the Snøhvit Sponsors. K-Line set out its proposals for those risks which it considered should be borne by K-Euro (and in doing so K-Line referred to the need to ensure that K-Euro retained its position as a "UK bona fide shipping company" for the tax purposes of the lease structure), and a number of ways in which the arrangements might be re-structured to achieve the sharing of risk. These proposals were not acknowledged or taken up by the other Snøhvit Sponsors.

248.The Snøhvit Sponsors, as economic owners of the Vessels through their shareholdings in Northern LNG, did eventually accept that they should indirectly take a share of the risks of K-Euro's anticipated losses in respect of the operation of the Vessels. To that end it was agreed that K-Euro would become, in effect, a special purpose company (that is, its sole business would be that of operating the Vessels), owned by the Snøhvit Sponsors. The Snøhvit Sponsors also agreed to reduce the bareboat hire by approximately five per cent for a period of three years following delivery. Finally, they agreed to become shareholders in K-Euro, as implemented in K-Euro's share capital reorganisation in October 2006, and to contribute further share capital to K-Euro.

249.The transfer out of all the non-Snøhvit business ensured that the rest of K-Euro's business was unaffected by the risk of losses arising from the operation of the Vessels and remained wholly within the ownership of the K-Line group.

250.The reorganisation also resolved two constraints on the development of the remaining part of K-Euro's business. First, commercial developments and the growth of the bulk carrier market meant that it was beneficial to bring the bulk carrier business within the tonnage tax regime and for that purpose that business had to be separated from the LNG carrier business. Secondly, the security arrangements in relation to the UK finance leasing of the Vessels, and in particular floating charges given over the assets and business of K-Euro, required K-Euro to seek the consent of the relevant parties having the benefit of those charges for any major business

transactions, and K-Line saw this as a potential limitation on its freedom to operate and expand its business based in the UK.

251. As a result of the reorganisation and the contracting out of the management of the Vessels to K-LNG, the audited report and financial statements of K-Euro (then renamed as Polar LNG Shipping (UK) Limited) for the year to 31 December 2006 (the year in which the Vessels were delivered) show the principal activity of the company to be "the operation and management of two LNG vessels". Turnover for that year is US$27.655m and there is an after-tax loss of US$0.005m. The company is shown as having one employee (that employee is part-time, and is a partner in a London firm of solicitors with a shipping practice who is not involved in operational matters). It retained directors (including Mr Misaki) expert in the operation of LNG carriers. The financial statements also show the reorganised share capital of K-Euro and a loan from shareholders to the company.

The operation of the Vessels

252. As set out above, from 2002 K-Euro engaged management and technical staff (by way of secondment from K-Line as well as recruitment in the market) in anticipation of the delivery of the Vessels and to develop the business of its bulk and gas division.

253. The operation of the Vessels by K-Euro extends to the supply and management of the crewing arrangements, the technical management of the Vessels, their commercial management, the arrangement of insurance cover, the provisioning of the Vessels in port, and the provision of accounting and financial management systems.

254. In 2003 the decision was taken to outsource the crewing of the Vessels to a third party. A principal reason for this was that K-Euro decided that officers and senior crew operating ships in the Atlantic Basin should be Europeans (and preferably Scandinavians, given the Norwegian "home" terminal used by the Vessels), and the K-Line group had limited experience of such crews. After a tender process, in the course of which crewing and training and other procedures were finalised, K-Euro appointed a crew management company, OSM, to supply and manage the crew for each of the Vessels. The appointment was finalised in January 2005, and crew recruitment began immediately thereafter.

255. K-Euro is responsible under the time charter for all aspects of technical operation of the Vessels, including arranging dry-docking of the Vessels, inspecting the Vessels, arranging repairs and maintenance, complying with safety management and environmental protection systems, and complying with LNG cargo handling procedures. In view of the specialised nature of LNG cargoes and carriers, technical management is usually carried out as part of the operation of the vessel rather than separately out-sourced to a third party.

256. Likewise, the commercial management of the Vessels, the arrangement of insurance, the provisioning of the Vessels in port, and the provision of accounting systems is the responsibility of K-Euro under the time charter.

257.Under the Ship Management Agreement K-LNG provides the agreed management services (crew management, technical management, insurance arrangements and accounting services) to K-Euro in relation to the Vessels as agent for K-Euro. Those services do not extend to matters of commercial management. K-Euro, through the agency of K-LNG, bears the costs of operating the Vessels in relation to the matters managed by K-LNG and K-Euro pays a fixed daily fee to K-LNG for the management services it provides.

Issue 1: is K-Euro responsible for defraying all, or substantially all, expenses in connection with the Vessels?

258.The first issue we are required to decide is whether, within the terms of section 123(1) CAA 2001, K-Euro, as the person who lets the Vessels on charter, is responsible for defraying all expenses in connection with the Vessels throughout the period of the charter or substantially all such expenses other than those directly incidental to a particular voyage or to the employment of the Vessels during the charter period.

259.It is helpful to set out here once more the provisions of section 123(1) CAA 2001:

> (1) *A ship is used for a qualifying purpose at any time when it is let on charter in the course of a trade which consists of or includes operating ships by a person who is—*
>
> *(a) resident in the United Kingdom or carries on the trade there, and*
>
> *(b) responsible for navigating and managing the ship throughout the period of the charter and for defraying—*
>
> *(i) all expenses in connection with the ship throughout that period, or*
>
> *(ii) substantially all such expenses other than those directly incidental to a particular voyage or to the employment of the ship during that period.*

260.For the purposes of this issue, and having regard to the terms of section 123(1) CAA 2001, it is common ground that K-Euro is resident in the UK, and that it is responsible for navigating and managing the Vessels throughout the period of the time charter. It is assumed that the Vessels are let on charter by K-Euro in the course of a trade which consists of or includes operating ships (this is a matter of dispute – it is the subject of Issue 2).

261.The Appellant's case is that K-Euro is responsible for defraying substantially all expenses in connection with the Vessels throughout the charter period, other than those that relate to a particular voyage or the particular employment of the Vessels, which are the responsibility of the Snøhvit Sellers as time charterers. The Appellant relies on the terms of the time charter for establishing the different responsibilities attaching to the respective parties. The Appellant further argues that the hire payments made by the charterers are, regardless of the way they fall to be computed, payments for hire of the Vessels and not a reimbursement of K-Euro's costs.

262.The Commissioners' case is that the effect of the provisions in the time charter for the payment of hire as it relates to the Operating Cost Element is that substantially all the operating costs of the Vessels are borne by the Snøhvit Sellers as time charterers since they are reimbursing K-Euro for such costs. Accordingly, they say, K-Euro is not responsible for defraying such costs.

The Appellant's submissions

263.Mr Peacock began by drawing attention to what he regarded as two oddities in the drafting of these provisions. First, that the qualification or exception for the expenses which it is permitted for the end-user charterer (rather than the ship operator) to defray ("…those directly incidental to a particular voyage or to the employment of the ship during that period") is limited to the second category (i.e. sub-paragraph (1)(b)(ii)) ("substantially all such expenses") and does not extend to the first category (i.e. sub-paragraph (1)(b)(i)) ("all expenses"). Secondly, that within that permitted exception, whilst "expenses …directly incidental to a particular voyage" clearly differentiates voyage-specific expenses (such as fuel for a voyage) which the user of a ship is likely to bear under a time charter from the general charter costs of the ship operator, "expenses …directly incidental …to the employment of the ship" is, on its face, a broad concept.

264.As to the first of those points, Mr Peacock referred to the antecedent legislation and its evolution in the course of Finance Bill debates, from which it appeared that the exception for voyage-specific and ship employment expenses more clearly applied in the case of both categories (that is, to qualify "all expenses" as well as "substantially all such expenses"). However, since K-Euro is, in his submission, within the circumstances of the second category (that is, it is responsible for defraying substantially all of the expenses in connection with the Vessels throughout the relevant period), K-Euro's case did not require us to decide upon this matter of interpretation.

265.The second of those points is relevant to K-Euro's appeal, since it is necessary to see what expenses K-Euro is responsible for defraying having regard to the terms of the bareboat charter and the time charter and then determine whether the statutory test is satisfied. Mr Peacock submitted that the expression "expenses …directly incidental …to the employment of the ship" must take its meaning from its context (so that it must be a proper cost of the charterer rather than of the ship operator because it is specific to the use of the ship), but nevertheless must mean an expense other than a voyage-specific expense. He gave the example of a cost consequential upon laying up a ship, such as port dues payable in the port in which the ship is laid up: that is not a cost of a particular voyage, but is an expense which properly falls to the charterer. The distinction made in the drafting may also reflect the distinction between the expenses of a charterer where the ship is hired on a voyage charter, and those of a charterer where the ship is hired on a time charter.

266.Mr Peacock next referred to the question of whether K-Euro is "responsible …for defraying" substantially all the relevant expenses. He pointed out that, by virtue of section 123(3) CAA 2001, a person is responsible for something if he is responsible

as principal or appoints another person (such as his agent) to be responsible in his place. He submitted that in the absence of any case law guidance or statutory definition as to the meaning of "defraying", the term should have its ordinary meaning which, by reference to the Oxford English Dictionary, he argued, is to pay, to pay out, to expend or to disburse money. The pertinent question is therefore whether, by reason of the chartering arrangements in relation to the Vessels, K-Euro is responsible for payment of substantially all of the relevant expenses: the question is not whether ultimately the cost in economic terms falls on K-Euro.

267. As to the question of whether K-Euro is responsible for defraying "substantially" all of the relevant expenses, that should be seen as a practical test or threshold. He suggested that if at least 70 or 80 per cent of the relevant expenses were defrayed by K-Euro then it could fairly be regarded as having defrayed "substantially all" such expenses.

268. Turning to the terms of the time charter, Mr Peacock referred to Clause 2, which obliges K-Euro to provide a crew for the Vessels who will undertake the voyages required by the charterers, and to Clause 6, under which K-Euro agrees to provide and pay for all the crew and (subject to specified exceptions) "for all requirements, costs or expenses of whatsoever nature relating to the Vessel and her Master, officers and crew". By this means, and having regard to section 123(1) CAA 2001, K-Euro has responsibility for defraying substantially all the expenses in connection with the Vessel. Conversely, by Clause 7, specified voyage-related costs (fuel, towage and pilotage, port charges, cargo loading and unloading) are to be provided or paid for by the charterers at their own cost unless the Vessel is off-hire (when the cost is for K-Euro's account). The specified exceptions to the Clause 6 costs borne by K-Euro (those exceptions include the cost of modifications necessary for the Vessel to dock at certain port terminals, or incremental costs of war risk where the charterers require the Vessel to trade in a war risk zone) Mr Peacock submitted are either voyage-specific expenses or charterers' expenses incidental to the employment of the Vessel, and hence are disregarded for the purposes of the section 123(1) CAA 2001 test.

269. In summary, therefore, Mr Peacock submitted that the arrangements for the chartering of the Vessels are consistent with the terms of section 123 (1) CAA 2001: K-Euro is responsible for defraying substantially all of the expenses in connection with the Vessels throughout the period of the charter except for specified expenses which are directly incidental to a particular voyage or to the employment of the ship at the instance of the Snøhvit Sellers as charterers.

270. Mr Peacock then dealt with the question of the payment of hire: despite the terms of the time charter described above which place on the respective parties obligations to pay particular costs, is K-Euro reimbursed its costs by means of the hire payment arrangements so that it cannot be regarded as defraying the costs it agrees to pay in relation to the Vessels? He referred to the relevant provisions in the time charter relating to the accrual and payment of hire in Clauses 8 and 9 and Addendum No 1 (see paragraphs 174 to 183 above). In his submission Addendum No 1 provides a formula, using the defined concepts of Capital Element and Operating Cost Element, by which the amount of the daily hire, in US dollars, is calculated, and that amount so

calculated is paid monthly in advance. What is paid by the charterers, calculated by this means, is paid as hire. It is not paid by way of reimbursement of K-Euro for the expenses it has incurred. All ship operators chartering their vessels will seek to agree a hire which ensures that their capital and operating costs are recovered together with a profit margin – that does not mean that those costs are paid by the charterer paying the hire.

271. Mr Peacock found support for his argument in the terms of Addendum No 1 relating to Fixed Operating Costs: those are to be calculated, for the first five years from delivery of the Vessel, by reference to a specified daily amount (which includes an annual escalation factor at the rate of 2.5 per cent). That daily amount may be an estimate of anticipated costs for manning, maintaining and repairing, and dry-docking the Vessel, but it is not a calculation of those costs as they actually arise: K-Euro is at genuine commercial risk that the actual costs will exceed the amounts taken to calculate the hire payment – which in fact is what actually happened when unexpectedly high crewing costs resulted in K-Euro facing a substantial loss, the prospect of which brought about the reorganisation of its business in advance of delivery of the Vessels. It is significant that the parties did not look to the terms of the time charter as the means to eliminate or mitigate that anticipated loss.

272. As to the provisions for adjusting the Fixed Operating Cost element of the hire for subsequent five year periods, Mr Peacock acknowledged that the drafting of Addendum No 1 is unclear, but he relied on the evidence of Mr Thomassen to the effect that the Snøhvit Sellers entered into the time charter arrangements on the basis of fixed costs, so that for each five year period the Fixed Operating Cost element would be agreed taking into account actual costs for manning, maintenance etc as they stood in the final year of the preceding five year period, but with no escalation. Mr Aoki, on the other hand, understood the bargain to be that a figure would be agreed for each year in the five year period in respect of the Fixed Operating Cost element based on actual costs for the final year of the preceding five year period, and with an annual escalation percentage increase which would be based on the actual annual percentage increase during that preceding five year period. Whichever of those interpretations was correct, neither of the parties understood that K-Euro would recover its actual operating costs by means of the calculation of the hire payment.

273. As to the insurance costs, the premiums paid by K-Euro for the agreed insurance cover are referred to in Addendum No 1 as "Pass Through Costs". Mr Peacock acknowledged that there was a direct correlation between the expense defrayed by K-Euro in paying such premiums and the amount included in the calculation of hire (although estimated figures are given for the first five years for the purpose of calculating the daily rate of hire). His principal submission was that the legal analysis remains that K-Euro defrays the expense of the insurance premiums, and that remains the case notwithstanding that part of the hire it receives has been calculated to take account of the amount of such expense. His further submission was that even if it could be said that the insurance costs are borne by the time charterers on the grounds that they are reimbursing K-Euro for its payment of the premiums, since, on the evidence to date, those costs have averaged less than eight per cent of the costs which K-Euro pays to K-LNG for the management and operation of each Vessel, it remains

the case that K-Euro is responsible for defraying more than 90 per cent of the expenses in connection with the Vessel, and thus "substantially all" such expenses.

The Commissioners' submissions

274.We were assisted by submissions made by Mr Cooper on behalf of the Commissioners. His submissions related to the nature and characteristics of a time charter and the allocation of control, risk and cost between the disponent owner and the time charterer, and he compared "standard" time charter arrangements (such as those to be found in the Shelltime 4 charter, a common form of tanker charter) with those entered into between K-Euro and the Snøhvit Sellers. His submissions were pertinent to Issues 2 and 4, as well as to Issue 1, and for convenience we record them here.

275.Mr Cooper referred us first to the authorities as to what constitutes a time charter, and in particular *Wilford on Time Charters* (sixth edition) at paragraphs I.4 to I.8. The essential nature of a time charter is that, in contrast to a bareboat, or demise, charter, it is not a lease of a ship, since the owner retains possession and the time charterer acquires a right to direct the use to which the owner puts his ship: "A time charter…is a contract for services to be rendered to the charterer by the shipowner through the use of the vessel by the shipowner's own servants, the master and the crew, acting in accordance with such directions as to the cargoes to be loaded and the voyages to be undertaken as by the terms of the charter-party the charterer is entitled to give to them": Lord Diplock in *The Scaptrade* [1983] 2 Lloyd's Rep. 253, at pp 256 and 257.

276.We were also referred to a more recent statement of the fundamental characteristics of a time charter, by Lord Hobhouse in the case of *Whistler International Ltd v Kawasaki Kisen Kaisha Ltd* [2001] 1 AC 638 at 652, where the contrast is made with a voyage charter:

> "A time charter is different. The owner still has to bear the expense of maintaining the ship and the crew. He still carries the risk of marine accidents and has to insure his interest in the vessel appropriately. But, in return for the payment of hire, he transfers the right to exploit the earning capacity of the vessel to the time charterer. The time charterer also agrees to provide and pay for the fuel consumed and to bear the disbursements which arise from the trading of the vessel."

277.In Mr Cooper's submission, in relation to both the bareboat charter of the Vessels to K-Euro and the time charter of the Vessels by K-Euro to the Snøhvit Sellers, the responsibilities between the parties normally accorded by a bareboat charter and a time charter are blurred both by the terms of the documents themselves, and the surrounding arrangements. In particular, K-Euro did not have the commercial autonomy which is to be expected of a disponent owner, since its role was circumscribed by the control exercised by Statoil and the other Snøhvit Sellers on the one hand and K-Line and the other Snøhvit Sponsors on the other. This raises the question of whether K-Euro has a commercial purpose within the overall arrangements for the financing and chartering of the Vessels.

278. This is seen, Mr Cooper argues, in the provisions relating to the payment of hire in Addendum No 1 to the time charter. First, K-Euro is entitled to pass on directly the costs of insurance (with the Snøhvit Sellers having a right to review all the insurance costs and a right to suggest changes to the insurance arrangements, requiring K-Euro to bear any additional costs if it failed to accept those suggestions). Secondly, K-Euro is entitled to pass on indirectly the specified Fixed Operating Costs, with an adjustment mechanism every five years, and with the Snøhvit Sellers having the ability to scrutinise such costs, and, in the case of dry-docking costs, to see a budget estimate and a breakdown. Furthermore, the provisions in Addendum No 1 which provide for an annual meeting in advance of each calendar year between K-Euro and the time charterers "for the purpose of establishing [estimated operating costs] with respect to that year" suggests that there was a mechanism by which annual adjustments could be made to ensure reimbursement of K-Euro in relation to such costs.

279. Mr Cooper also drew our attention to the specific provisions in the time charter relating to dry-docking. He acknowledged that it is not uncommon in a time charter for the charterer to have a say as to when the dry-docking is to take place, but the additional rights of the charterers in the present case to review the works to be done and the costs of dry-docking go beyond the normal protection for charterers and gives them a greater degree of involvement and, in practice, a degree of control in relation to such matters.

280. With regard to insurance, Mr Cooper pointed out that there is specific requirement in the time charter for K-Euro to arrange for the hull and machinery insurance to provide for a deductible in a specified amount, and it is provided that the charterers will bear the cost of such deductible by reimbursing it to K-Euro. Further, the time charter provides in Addendum No 1 that insurance premiums are included in the operating element of hire, and by this means the owner is reimbursed the costs it incurs on such premiums.

281. Mr Cooper also pointed to arrangements beyond the time charter itself to show that K-Euro did not, overall, bear the risks of disponent owner. He referred to K-Line's letter to the Snøhvit Sponsors of 10 January 2003 with regard to risk allocation and K-Line's understanding set out in that letter that the Snøhvit Sponsors, rather than K-Euro, should take the risks and benefits of operating the Vessels, as co-owners. He referred to the 2006 reorganisation of K-Euro's business and the reduction in the bareboat charter hire. He argued that the terms of the bareboat charter were unusual in that it imposes substantial obligations on K-Euro, including the requirement that its rights are subordinate to the rights of the Appellant as superior lessor, and K-Euro, as bareboat charterer is required to accept delivery of the Vessel whatever its condition, notwithstanding that it had no role in supervising construction or delivery of the Vessel. He referred to certain of the security documents, under which K-Euro is restricted from amending its rights, and is restricted in its entitlement to deal with time charter hire payments it receives into its bank account. In Mr Cooper's submission all these factors indicated that K-Euro had no independent or commercial function or purpose in the overall leasing arrangements.

282.Mr Ewart then made particular submissions as to the meaning of "responsible for defraying" and as to what is meant by "substantially all such expenses", and how those terms apply in the present case.

283. As to "defraying", Mr Ewart submitted that it can mean, depending upon context, both "to pay" and "to reimburse", since the person who bears a cost defrays it. Thus if a party pays an expense but has a right to be reimbursed or indemnified for his expense by a second party, it is that second party who defrays the expense because he is legally liable to make the reimbursement or pay out under the indemnity, and therefore it is he who bears the cost. In the context of section 123(1)(b) CAA 2001 it is necessary to look to the substantive point of who bears the expense rather than the formal requirement of who makes the payment, since that is the way to determine whether the time charter is of the kind which will constitute a qualifying use.

284.With regard to the insurance premiums, the terms of Addendum No 1, which, in saying how the Operating Cost Element is to be determined, refer simply to "Pass Through Costs – this category covers all premiums of [specified classes of insurance]", make it clear that there is a legal obligation on the time charterers to pay those amounts to K-Euro, in effect by reimbursement, and therefore they, and not K-Euro, defray that expense. That is the legal position and it accords with the economic substance of the arrangement between the parties. Addendum No 1 is less specific in its terms as to the Fixed Operating Costs, but they can be read as an indirect reimbursement if, each year, there is an adjustment by reference to the actual costs of the previous year.

285.With regard to the "substantially all" test, Mr Ewart argued that it is not simply an arithmetic test of comparing the amount of the expense in question against the total expenses, as the Appellant had proposed, but it is a question of whether the amount in question is substantial in its own right and whether, in its nature and significance, it is peripheral or central. In the present case the amounts paid in respect of insurance for each of the Vessels were in the order of US$300,000 to US$400,000 per annum, which is a substantial amount, and those amounts relate to a matter of central significance to the operation of the Vessels, namely insurance cover for the Vessels themselves and for loss of hire and other commercial risks.

286.In summary, therefore, the Commissioners argue that it is the Snøhvit Sellers, as time charterers, who defray the operating expenses in connection with the Vessels by means of their reimbursement of K-Euro through the mechanism of the hire payment. They argue that this is certainly the case with regard to the insurance premiums paid by K-Euro, and by reason of this alone K-Euro cannot say that it is responsible for defraying substantially all expenses in connection with the Vessels other than the permitted exceptions of voyage-specific expenses and expenses incidental to the employment of the Vessels.

Discussion

287.As the case developed in argument before us Issue 1 became focused on the rather narrow and specific question of the proper interpretation of just two pages of

the time charter, namely those parts of Addendum No 1 which relate to the Operating Cost Element of the hire rate payable by the Snøhvit Sellers as time charterers to K-Euro as disponent owner.

288.The Commissioners did not dispute the basic proposition put forward by the Appellant that, under the bareboat charter and the time charter, K-Euro alone is obliged to pay the expenses which, in the terms of section 123(1)(b) CAA 2001, are the "expenses in connection with the ship" throughout the period of the charter (other than those expenses which are the permitted exceptions).

289.Mr Cooper argued that there are unusual features of both the bareboat charter and the time charter, and that, having regard to those and the wider arrangements between the parties, K-Euro should not be regarded as having the control or commercial role which one would expect to find were it in reality a disponent owner of the Vessels. But those points go to the question of whether K-Euro was letting the Vessels on charter in the course of a trade of operating ships (Issue 2) and the question of whether a main object of the bareboat charter and the time charter was to enable writing-down allowances to be claimed (Issue 4), and we deal with those points, as appropriate, below when considering those Issues.

290.Mr Cooper also argued that it was never the intention that K-Euro should incur losses, and that when the likelihood of such losses arose K-Line was quick to remind the Snøhvit Sponsors of that fact and to seek to mitigate them (as eventually happened by means of the 2006 reorganisation). But (and rightly in our view) that was not advanced as an argument that K-Euro was not liable for the expenses which, had it not been for the mitigating action, would have given rise to such losses.

291.As we have summarised in paragraph 268 above, Mr Peacock took us in some detail through the terms of the time charter to identify the liabilities and costs imposed upon K-Euro and those imposed upon the time charterers. His analysis, which we accept, is that the liabilities and expenses reserved to the time charterers are limited to those which, in the terms of section 123(1)(b) CAA 2001, are "directly incidental to a particular voyage or to the employment of the [Vessel] during" the period of the charter, and that all other liabilities and expenses in connection with the Vessel throughout the charter period are the responsibility of K-Euro.

292.The Commissioners also accept, it would appear, that K-Euro remains liable (or, in the terms of section 123(1)(b) CAA 2001, responsible) to pay such expenses notwithstanding that, following the 2006 reorganisation, it is K-LNG, as the manager of the Vessels appointed for the purpose by K-Euro, which contracts with third parties and makes payment to them. That would in any event in our view be the correct analysis, having regard to the principal and agent relationship created by the Ship Management Agreement and having regard also to the provisions of section 123(3) CAA 2001.

293.Before turning to the detail of its hire payment provisions we have some general observations to make about the time charter.

294.First, we note that the time charter, both in its general shape and its particular provisions, is designed to meet the requirements of the Snøhvit Sellers. Statoil, through the particular agency of Mr Thomassen, conceived it and Mr Thomassen was its principal architect. All the material terms (at least as to their principle) were in place when it was put out to tender, although those terms were refined in the tender process and the exact financial terms were negotiated in the course of that process. The Snøhvit Sellers were clear that although they needed a long-term and reliable arrangement to ship their LNG to fulfil their long-term supply contracts, they did not want to own or operate the tankers required for that task, but instead would entrust those functions to shipowners with the relevant expertise. By means of the provisions in the time charter they sought to provide for their requirements, and to differentiate between the respective responsibilities of the shipowner/operator and themselves as users of fully operating and provisioned vessels.

295.The Snøhvit Sellers required a long-term arrangement for the use of each of the Vessels, which were ships designed and built for the particular purpose of shipping LNG from the far northerly terminal constructed by the Snøhvit Sellers onshore from the gas fields. A time charter for a term of at least twenty years and possibly thirty years is unusual in relation to general shipping, but Mr Thomassen's evidence (which we have no reason at all to doubt) is that at the time of the tender process such long-term charters were generally a feature of the then nascent LNG carrier trade – producers required such arrangements for the reasons that the Snøhvit Sellers required them. It explains a number of the features of the time charter, including the following: that the shipowner recovers, or largely recovers, the cost of the Vessel over the term by means of the hire received; that the shipowner recovers by the hire received its costs of operating the Vessels and also the opportunity to make a profit margin; that the time charterers are kept informed of key items of the shipowner's expenditure, such as insurance, when they are to be factored in to the hire paid; and that the time charterers have a close involvement in key issues relating to when the Vessel is out of service, such as the timing and extent and estimated cost of dry-docking.

296.The time charter was not structured with the terms of section 123 CAA 2001 (or, indeed, of any other UK tax provision) in mind. At the time Mr Thomassen and his colleagues drew up the terms of the time charter in early 2001 they had no knowledge of or interest in such matters. Nor did they have any reason to think that a shipowner who might successfully tender for the time charter would have any such interest. It is true that by the time the time charter was entered into K-Line were contemplating a UK finance lease as a means of financing the Vessels, and the time charter anticipates that a novation may be required to accommodate whatever means K-Line pursues to finance the Vessels, but that was not, as far as we can see, an influence on the terms of the time charter.

297.Turning to the detail, and the case each party argued before us with regard to Issue 1, the essential difference between them is whether K-Euro is reimbursed by the time charterers for certain of the operating expenses it incurs in relation to the Vessels so that it is they, and not K-Euro, which is responsible for defraying those expenses.

298.With regard to the meaning of "responsible for defraying", we agree with Mr Ewart that if party A is liable to pay an expense to party C in circumstances where party B has agreed unequivocally and by legally binding obligation to reimburse A for that expense should A incur it, then as a matter of legal obligation (and not simply as a matter of economic burden or cost) it is correct to say that B is responsible for defraying that expense. Where we depart from Mr Ewart is in the interpretation of the relevant provisions of the time charter: we do not agree that they comprise such a reimbursement arrangement as leads to that conclusion.

299.The starting point is that the time charterers are required to pay hire to K-Euro as the compensation for K-Euro providing the Vessel upon the terms of the time charter. That hire accrues in accordance with Addendum No 1. There is specific mechanism for payment of the hire. Addendum No 1 provides that "hire payable under this Charter shall consist of a Capital Element and an Operating Cost Element each of which shall be determined in accordance with this Addendum No 1". This is followed by provisions which tell us how the Capital Element is calculated (to give an amount per day) and then how the Operating Cost Element is calculated (with a specified amount per day for years one to five).

300.Therefore, that which K-Euro is entitled to receive is hire calculated in a particular way so as to give a daily rate or amount of hire. It is not, in terms, entitled to seek reimbursement from the time charterers for an expense it has incurred. If the hire is not paid K-Euro's action against the time charterers is for payment of the hire accrued, not an action to be reimbursed a particular sum which it has expended. It is perfectly possible to conceive of circumstances where the time charterers could raise a valid defence to a claim for payment of the hire (for example, if the Vessel were for some reason not available to the time charterers) whereas if the contract were one of reimbursement the obligation to pay would arise once the expenditure in question had been made. That, quite simply, deals with the point. Taking Mr Ewart's view as to what constitutes responsibility for defraying expenses, it is not the case that the time charterers have agreed to indemnify or reimburse K-Euro in relation to its expenses and thereby have a legal obligation to meet those expenses: they have agreed to pay an amount of hire, which is something different.

301.Further, it cannot be argued that this is reimbursement dressed up as hire. That becomes clear if we look at that part of the Operating Cost Element referred to in Addendum No 1 as the Fixed Operating Cost. In the tender process it appears that the parties, in 2001, fixed on their estimate of what those costs (for manning, maintenance and repair, and dry-docking) would be for each of the first five years following delivery (itself some four to five years thence), incorporating an escalation factor at the annual rate of 2.5 per cent. Those figures are then shown in Addendum No 1 as a daily amount, and as such, a component in the calculation of the daily rate of hire. There is nothing in the terms of the time charter that provides that, during those five years, those figures are adjusted to take account of the actual operating costs which K-Euro incurred: they are, as the title given to them suggests, fixed. There is reference to the parties meeting annually "for the purpose of establishing estimated operating costs", but that does not tie in to any mechanism for adjusting the calculation of the daily rate for any year. Mr Thomassen's evidence was that this was an information-

sharing exercise to enable the parties to reach an agreement, when required, as to the level at which costs should be fixed for the subsequent five-year period.

302.Neither is there anything in the evidence to suggest that in fact those amounts were intended to be or were in fact so adjusted. Mr Thomassen's evidence is that the purpose of the Fixed Operating Cost provisions was to fix an amount of hire which would allow the operator to at least meet its estimate of what its expenses would be, but that an important factor for the time charterers was the certainty of the amount of hire, at least for each five year period.

303.The matter is put beyond any doubt, in our view, by what actually happened between the date of the time charter and delivery. K-Euro discovered that its costs for crewing the Vessels would exceed very considerably their expectations, so that it knew it would be faced with a significant loss if matters continued on that basis. Were it the case that K-Euro was entitled to increase the Fixed Operating Cost to meet that excess then that would have resolved the point. But it had no contractual right to do that and the Snøhvit Sellers stood by their side of the bargain in the time charter: other measures, effected in the 2006 reorganisation, had to be employed to assist K-Euro.

304.There was some debate as to the agreement between the parties as to the means of ascertaining the Fixed Operating Cost for the second and subsequent five-year periods during the term of the time charter. The drafting is obscure, providing, after a reference to the annual escalation rate, "the applicable rate shall be reviewed and agreed taking into account the actual costs incurred during the previous five years period, the Vessel's age and trades". Mr Thomassen and Mr Aoki had different views, as we have referred to above, as to how the costs would be rebased for a subsequent five-year period and whether or not there would be an escalation factor and if so, whether that would be based on what had proved to be the actual incremental increase in actual costs over the previous five years. Neither of them understood that there would be, as it were, a recouping in year six, or over the forthcoming five years, of any shortfall in the operating costs used in the calculation for the previous five years as against K-Euro's actual costs for that period. Again, therefore, there is nothing by way of reimbursement, direct or indirect, in these provisions.

305.Mr Ewart and Mr Cooper were more pressing in their case in relation to what are described in Addendum No 1 as the Pass Through Costs, being the premiums in respect of the insurance cover which K-Euro was required to put in place. Addendum No 1 provides no more elucidation than that simple description to explain how the hire rate calculation takes account of such costs. A table for the first five years sets out a daily rate for each of those years by reference to the different types of insurance cover, but those amounts are specifically identified as "estimated". There is nothing to show if and how such estimated daily rates are adjusted by reference to actual premiums paid by K-Euro. In the insurance Appendix to the time charter there is a heading "Reimbursement of Owner", but the provision refers simply to Addendum No 1.

306. There was no clear evidence on the matter, but we are prepared to assume that, by some adjustment mechanism, that part of the Operating Cost Element in the calculation of the hire which comprises the Pass Through Costs operates so that the amount of the hire includes an amount which equals the insurance premiums paid by K-Euro. This is not the case if and to the extent that K-Euro disregards the recommendations of the time charterers and in consequence pays a higher premium.

307. Given our view that what the time charterers pay and what K-Euro receives is hire for the use of the Vessel and not reimbursement by them of the expenses which K-Euro incurs in order to make the Vessel available to them as required by the time charter, the fact that an element of the hire is calculated by reference to the actual premiums paid does not result in the time charterers being responsible for defraying the expenditure on the insurance premiums, even taking account of Mr Ewart's definition of that concept.

308. If we are wrong in that, so that in paying the hire representing the Pass Through Costs the time charterers, rather than K-Euro, are responsible for defraying the insurance premiums, can K-Euro nevertheless rightly claim that it remains responsible for defraying "substantially all" the expenses of operating the Vessel?

309. The phrase is "all…or substantially all". That does, it seems to us, look essentially to the quantum (or proportion of quantum) of the expenses rather than to their nature: "all" (certainly with regard to a group of expenses) is the totality or aggregate without any concept of nature or characteristic, and where that totality is qualified to indicate something less than the totality or aggregate it requires clear language to introduce the concept of nature or characteristic to show that the totality is to be qualified by reference to such concepts. "Substantially all" does not do that. There is nothing in the context of the provision which points to the exercise Mr Ewart would have us carry out, attributing a significance to the different expenses (in his terms, central or peripheral) to judge whether or not a threshold has been reached. The purpose of the provision is to enable the qualifying use test to apply notwithstanding that some of the ship operating costs – a small proportion relative to all of them –are met by the user of the ship: the nature of the costs which the user meets is not a factor.

310. In the present case in each year to date K-Euro has been responsible for defraying more than 90 per cent of the ship operating costs even if it is the case that it is not responsible for defraying those costs which relate to insurance. We consider that it has therefore been responsible for defraying substantially all expenses in connection with the Vessels throughout the charter period, other than those directly incidental to a particular voyage or to the employment of the ship during that period.

311. Accordingly, we decide Issue 1 in the Appellant's favour.

Issue 2: does K-Euro let the Vessels on charter in the course of a trade which consists of or includes operating ships?

312.The second issue we are required to decide is whether K-Euro lets the Vessels on charter in the course of a trade which consists of or includes operating ships – it is a requirement of section 123(1) CAA 2001 that it should so let the Vessels if they are to be regarded as used for a qualifying purpose.

313.The question of whether K-Euro lets the Vessels in the course of a trade looks to the period beginning with the delivery of the Vessels in 2006. By that time the 2006 reorganisation of K-Euro's business had taken effect, so that its only activity was taking hire of the Vessels under the bareboat charter and hiring the Vessels to the Snøhvit Sellers under the time charter. Pursuant to those arrangements K-Euro was responsible for operating the Vessels, and it contracted out the tasks required to do that to K-LNG under the Ship Management Agreement.

314.The Appellant's case is that K-Euro was engaged in the activity of operating the Vessels; that it carried on a trade consisting of operating ships; that it let the Vessels on charter; and it did so in the course of its trade. Any fiscal motive which there may have been on the part of K-Euro or on the part of K-Line in requiring K-Euro to participate in the transactions comprising the letting of the Vessels is not relevant to the question of whether a trade is actually carried on by K-Euro.

315.The Commissioners' case is that, if one looks to the overall arrangements entered into by all the relevant parties, K-Euro's part in those arrangements with regard to the hiring and operating of the Vessels lacked commerciality. Therefore, although K-Euro lets the Vessels as a matter of the contracts it entered into, it does not do so in the course of a trade.

The Appellant's submissions

316.Mr Peacock submitted that there was no challenge to the reality of the transactions which K-Euro has engaged in and, given the evidence, no basis for any such challenge. K-Euro has taken a lease of the Vessels under the bareboat charter and has let the Vessels on time charter terms to the Snøhvit Sellers. It is responsible for the operation of the Vessels and has engaged K-LNG to ensure that the Vessels are properly operated so that those responsibilities are discharged. Those responsibilities extend to the crewing, supplying and provisioning of the Vessels; their technical and commercial management; maintaining the requisite insurance cover; and providing record-keeping and accounting services. In carrying out those activities on K-Euro's behalf K-LNG employs the services of a substantial number of staff. All those transactions are in themselves commercial and of a trading nature.

317.Mr Peacock further submitted that even if (which the Appellant did not accept) there was a fiscal motive on the part of those entering into the transactions in that they procured that K-Euro should take the role of disponent owner in order to enable the Appellant to claim capital allowances, such a motive is not relevant to the question of whether K-Euro is actually carrying on a trade. He referred to *F.A. & A.B. Ltd v Lupton (Inspector of Taxes)* [1972] AC 634 as authority for the proposition that it is

necessary to look at the form and characteristics of what is said to be the relevant trading transaction to determine whether it is such, not whether that transaction was motivated by an intention to achieve a particular tax benefit or result. Fiscal considerations, such as the availability of capital allowances, may be the paramount inducement for a taxpayer to enter into a transaction, but that is relevant only if it affects the commerciality of a transaction because then it will no longer be a trading transaction in its form and characteristics: *Ensign Tankers (Leasing) Ltd v Stokes (HM Inspector of Taxes)* 64 TC 617 at 697 (the judgement of Millet J). Mr Peacock also referred us to the decision of the Court of Appeal and its review of authorities in *New Angel Court Ltd v Adam (HM Inspector of Taxes)* [2004] 1 WLR 1988 and the decision of the House of Lords in *Barclays Mercantile Business Finance Ltd v Mawson (HM Inspector of Taxes)* [2005] 1 AC 638.

318. Mr Peacock also argued that any fiscal motives which there might have been on the part of the Appellant or K-Line or the Snøhvit Sellers in structuring the transactions so that capital allowances were available to the Appellant could have no bearing on the question of whether the activities of K-Euro amounted to a trade, just as in the *Ensign Tankers* case the fact that the partners in the limited partnership in that case were motivated by the wish to obtain capital allowances did not impugn the trading nature of the activities of the limited partnership itself.

The Commissioners' submissions

319. We have already referred to Mr Cooper's submissions with respect to the terms of the bareboat charter and the time charter which K-Euro entered into and his argument that K-Euro had no independent or commercial function or purpose in the overall leasing arrangements (see paragraphs 277 to 281 above).

320. Mr Ewart developed this line of argument. He said that the evidence showed that K-Euro had exercised no independent action in entering into the leasing arrangements, but had simply done what K-Line had told it to do: there was no commercial negotiation carried out by K-Euro and no commercial reason why K-Euro should become the disponent owner of the Vessels. The evidence showed that K-Line was concerned to structure the arrangements so that K-Euro would earn just such a profit as would enable it to claim that if was "a bona fide shipping company", so that the capital allowances would be secured. By the time the Vessels were delivered, K-Euro's role had diminished to virtually nil, since all the activities were carried out by K-LNG, and K-Euro's only employee had company secretarial functions only. The transactions it entered into were not in reality transactions which had the form and characteristics of the trade of chartering ships, but were transactions which were designed to achieve a tax benefit and for that purpose were given the colour of trading. It could not be said that K-Euro acted in a commercial manner with regard to the Vessels. Mr Ewart did not disagree with Mr Peacock's understanding of the ratio of the decision in *F.A. & A.B. Limited v Lupton*. In his view K-Euro's circumstances fell within the scope of that decision, since the absence of any commerciality on K-Euro's part with regard to the transactions and the chartering of the Vessels resulted in those transactions lacking the characteristics of a trade.

Discussion

321.The question we have to decide is whether K-Euro is carrying on a trade consisting of or including operating ships and if so whether the Vessels were let on charter in the course of that trade. As mentioned, that question falls to be answered by reference to K-Euro's activities in the period beginning with the delivery of the Vessels (strictly, the delivery of the first of the Vessels, in February 2006).

322.By that time K-Euro was a quite different animal from what it had been prior to the 2006 reorganisation. Its audited report and financial statements for the year ended 31 December 2005 give an indication of the nature and extent of its activities in the period immediately prior to the 2006 reorganisation (see paragraph 216 above). After the reorganisation it had shed all its activities save for the chartering of the Vessels, and it had outsourced the operation of the Vessels to K-LNG. Its audited report and financial statements for the year ended 31 December 2006 show how matters stood following the reorganisation and the commencement of the chartering of the Vessels once they had been delivered (see paragraph 251 above).

323.In answering the question as to whether or not K-Euro is trading in the post-delivery/post-reorganisation period it seems to us that we should have some regard to K-Euro's activities in the preceding period. This is so for at least three reasons. First, those activities provide, in some measure, a context in which to judge the nature of the activities in the later period, especially since the 2006 reorganisation was not in itself motivated by the need or desire to change the inherent nature of K-Euro's activities (the need was to "isolate" the Snøhvit transactions from the bulk carrier and the other LNG carrier activities). Secondly, the letting of the Vessels, although it commenced on delivery, was put in place by transactions entered into in that preceding period (as far back as September 2002 and contemplated in December 2001) and without any expectation of what occurred subsequently in the 2006 reorganisation. Thirdly, the development of K-Euro's business (both with regard to the activities undertaken to equip it so as to be in the position whereby it could operate the Vessels on delivery and with regard to the general growth of its bulk and gas carrier activities) in the period up to the 2006 reorganisation is relevant to help judge the form and characteristics and also the commerciality of the position as it stood following delivery of the Vessels.

324.There is no significant difference between the parties as to the guidance we should derive from case law when considering whether or not K-Euro is trading. From the line of cases which have analysed and applied *F.A. & A.B. Limited v Lupton* it is clear that the proper approach is to look to the purported trading transaction – at what actually happens – and then discern whether, in its form and character, it is a trading transaction. It is irrelevant that the transaction was entered into with the intention of securing a tax benefit, such as obtaining capital allowances for expenditure incurred, unless that results in the transaction so lacking commerciality that it cannot be said to have the form and character of a trading transaction.

325.What actually happens in the case of K-Euro – what it actually did – is that it entered into a bareboat charter pursuant to which the Vessels have been made available to it on lease for a substantial period of time. It also entered into a time

charter of the Vessels, again for a substantial period of time, pursuant to which it has agreed to make the Vessels available on terms whereby it operates the Vessels at its cost. At the time it entered into those arrangements it anticipated that it would directly undertake all the operational activities necessary to meet its obligations to the time charterers, drawing on its existing expertise and resources utilised in its other shipping activities, and building further expertise and resources from April 2002 as it expanded its business in the period running up to anticipated delivery. The 2006 reorganisation resulted in a different state of affairs: the larger part of K-Euro's bulk and LNG carrier businesses, and the expertise, staff and other resources required to operate them, were transferred out of K-Euro, so that K-Euro, through the Ship Management Agreement, engaged K-LNG to supply to K-Euro the services and facilities K-Euro required to operate the Vessels in compliance with the time charter.

326. Mr Cooper argued that certain of the features of the time charter were unusual, but we saw nothing that was uncommercial in the arrangements between K-Euro and the Snøhvit Sellers: they were negotiated between parties acting at arm's length and motivated solely by commercial factors. As we have said, those features where the time charter may be said to depart from the norm can be accounted for by the particular requirements of the Snøhvit Sellers acting under Mr Thomassen's guidance and by the unusually long term of the time charter (itself a commercial requirement of the Snøhvit Sellers, and, as Mr Thomassen explained, at the time of the tender process a requirement generally in the case of LNG tanker chartering).

327. Mr Cooper also argued that the bareboat charter had features which called into question its commerciality. He mentioned the payment of hire which delivered, over the period of hire, the value of the Vessels to K-Line and the other Snøhvit Sponsors (the head lessees of the Vessels), and he also mentioned the security and other arrangements in favour of the Appellant as ultimate owner of the Vessels whereby certain of K-Euro's rights were subordinated to the interests of the Appellant in that capacity. We do not consider that those features are so significant as to give a particular nature and character to K-Euro's transactions. As a matter of commerciality, if a shipowner leases a vessel on bareboat charter terms for a period of 20 or 30 years then he is likely to seek a return in the hire he receives which reflects the capital value of the vessel (and, correspondingly, the charterer in such a case is likely to recover a corresponding amount when letting the vessel on a long-term time charter). As to the security and other arrangements, any party financing the purchase of a vessel (whether by finance lease or loan) is most likely to insist on protecting – the borrowing party might say over-protecting – its interests and for that purpose securing the income flow derived from the operation of the vessel so that it is available to discharge the ultimate financing obligations. An interim party, such as K-Euro in this instance, has the benefit of the use of the vessel at a rental which, to a degree, reflects the favourable terms of the financing, and therefore is indirectly a beneficiary of the financing and might in consequence expect to be drawn into the security arrangements affecting the flow through of the income from the vessel. We see nothing uncommercial in that, although we do note that some of these constraints limited the free hand which K-Euro had to extend its business (which was a subsidiary reason for the 2006 reorganisation).

328.Mr Ewart argued in this regard that it was not commercially required that K-Euro should be a disponent owner of the Vessels – the commercial requirements of the Snøhvit Sellers would have been met if K-Euro had managed the ship on behalf of K-Line and the other Snøhvit Sponsors. It is true that Mr Thomassen and his colleagues required that the person with day-to-day responsibility for operating the Vessels should be based in a European time zone, and that this did not necessarily entail that such person should have a property interest in the Vessels (although there was a preference that this should be the case). But that is not to say that the transactions actually entered into by K-Euro with respect to the Vessels were inherently uncommercial. The activity of managing a vessel is different in nature from that of operating a vessel as disponent owner. There may be many reasons why a party chooses to undertake one kind of activity rather than another, including the respective risks and rewards, the nature of the relationship with a customer, and the consequences for other existing or proposed business activities. We do not consider that the transactions actually entered into by K-Euro can be disregarded or denied as trading transactions because it might have entered into a transaction of a different nature.

329.Mr Ewart questioned the commerciality of K-Euro's transactions on the grounds that it was little more than a cipher or puppet of K-Line and the other Snøhvit Sponsors. He pointed out that all the negotiations for the transactions to which K-Euro was a party had been carried out by K-Line executives in Japan and that the minutes of certain key board meetings had been drafted by K-Line's solicitors. He also pointed to the fact that all the activities which K-Euro was required to carry out to operate the Vessels were devolved to K-LNG.

330.We do not agree with Mr Ewart's characterisation of the role of K-Euro. First, we note that K-Euro was at the material times a wholly-owned subsidiary of the K-Line group, and therefore, to a large degree, likely to be compliant with the requests or directions of the group parent company in carrying out transactions for the ultimate benefit of the group as a whole and for which it had been identified as particularly suited. That is how large groups of companies work. It does not mean that the subsidiary so identified and conforming to such requests and directions by entering into the transactions is acting uncommercially so as to call into question the trading character of those transactions – it is necessary to see whether in so conforming it undertakes activities which comprise its trade or part of its trade.

331.This brings us to the second point: K-Euro was a company of some significant substance in April 2002 with a range of shipping and shipping agency activities which it carried out for its own account as part of the European operations of the K-Line group. Its directors, in carrying out those activities, were no doubt answerable to its parent company shareholder, but there is nothing in the evidence before us to suggest that they acted upon instructions to undertake activities lacking in commerciality. There is one telling piece of evidence to the contrary: when the parent company first raised the possibility with K-Euro's board in the course of the tender process that it should charter the Vessels to the Snøhvit Sellers the board were reluctant for K-Euro to be involved, on the grounds that K-Euro did not have the necessary expertise or resources for such a specialist task and therefore lacked both the ability to carry it out

and the credibility to tender for it. It appears that there was also concern about the operational risks which K-Euro might incur. It was only when K-Line, after the successful tender, set this in the context of its wider strategy to develop the group's business in Europe through the local hub offered by K-Euro, and, in pursuit of that, agreed to enable K-Euro to equip itself with the expertise and resources required to achieve that, that K-Euro agreed to take on the chartering of the Vessels.

332.It is certainly true that negotiation of the lease terms for the financing of the Vessels which K-Line had agreed to purchase was undertaken by K-Line employees, and that those terms were reflected in the bareboat charter between Northern LNG and K-Euro. That is not surprising since K-Line itself (through its shareholding in Northern LNG) had a principal interest in the head lessee, and it is reasonable to assume that financing expertise resided in the finance department at the group's head office and not with the operating subsidiaries. We do not think that that tells against the commercial nature of K-Euro's activities with regard to the chartering of the Vessels. Nor do we attribute much significance to the fact that certain key board minutes were drafted in part by the solicitors acting for the K-Line group in the leasing transactions: the question is not who drafted the minutes, but whether they are a proper account of the deliberations and decisions of the board at the meeting of which they purport to be a record. We saw no evidence that this was not the case, nor was there any challenge to the competence of the directors to exercise a judgement or reach a decision on the matters in question.

333.The third point is that, once K-Euro had entered into the bareboat charter and taken a novation of the time charter, it set about the task of equipping itself to ensure that it could operate the Vessels in accordance with the obligations it had undertaken in those documents. This was carried out in the broader context of K-Euro establishing a bulk and LNG carrier business according to a phased business plan which the board of K-Euro regularly reviewed. Mr Misaki's evidence was clear and compelling in this regard. Staff were engaged (both by secondment from K-Line and by direct recruitment) with the necessary range of technical and commercial management expertise; where specialist services were required which could not be supplied by internal expertise (for example, the engagement and management of crew with knowledge of North Atlantic waters and seaboard ports and with relevant language skills), supply contracts were entered into with appropriate specialist suppliers; and throughout there was full liaison with the Snøhvit Sellers.

334.Taking these points together we have no hesitation in concluding that K-Euro's activities have the form and characteristics of trading. Both with regard to the operation of the Vessels and the broader business of which the operation of the Vessels formed a part, it was engaged on its own account in a serious, substantial and properly managed business endeavour. That endeavour was intended to result in a profit which reflected both a management fee and a mark-up on operating costs, and thus a profit which accorded with K-Euro's position as an operator rather than a manager, and which also took account of the risks of that position. As it happened those risks eventually proved to be real: certain market conditions moved against K-Euro (especially as to the cost of manning the Vessels) and it became clear that losses would result once the chartering arrangements took effect on delivery of the Vessels.

It therefore cannot be said that the trading nature of those activities falls to be disregarded – that in fact they cease to be trading activities – because they lack commerciality.

335.The only remaining question is whether there should be a different conclusion having regard to the post-2006 reorganisation of K-Euro's business and share capital, since it was in this pared-down form that K-Euro actually embarked upon the operation of the Vessels. We think not. For the reasons we have already given, the pre-reorganisation position must inform the nature of the post-reorganisation activities of K-Euro. Further, K-Euro retained the obligations to operate the Vessels after the reorganisation to the same extent as before, and discharged those obligations at its own cost. That it discharged those obligations through the management agency provided by K-LNG supplying the necessary services to K-Euro cannot change the form and characteristics of the ship operating activities undertaken by K-Euro. It does not matter whether the twenty or more individuals who, by Mr Misaki's evidence, are variously engaged in the variety of activities required to operate the Vessels, are directly engaged by K-Euro, or whether instead K-Euro has the benefit of their endeavours by means of the services and management contract it has entered into with K-LNG.

336.The only material difference consequent upon the 2006 reorganisation is that the activities of K-Euro have been reduced so that its sole activity is the operation of the Vessels: that activity is no longer part of a wider business enterprise, and on any basis K-Euro's trading activities must be regarded as shrunken. Have they been shrunken to the point that they no longer comprise a trade? We do not think that this is the case. The operation of a single vessel is in itself a substantial business venture. The audited report and financial statements of K-Euro for the year ended 31 December 2006 indicate the size of the business retained by K-Euro by reference to its turnover. It is the case that it retains a trade by virtue of chartering and operating the Vessels alone.

337.We therefore conclude that K-Euro lets the Vessels on charter in the course of a trade which consists of or includes operating ships.

338.Accordingly, we decide Issue 2 in the Appellant's favour.

Issue 3: does section 123(4) CAA 2001 apply in the circumstances where section 110 (rather than section 109) CAA 2001 is in point, namely where there is overseas leasing and no qualifying purpose but the taxpayer is entitled to no allowances instead of 10 per cent allowances?

339.This is a narrow point of statutory interpretation of the terms of section 123(4) CAA 2001. It is helpful to set out the subsection here:

> *(4) Subsections (1) and (2) do not apply if the main object, or one of the main objects—*
>
> *(d) of the letting of the ship … on charter,*

(e) of a series of transactions of which the letting of the ship … on charter was one, or

(f) of any of the transactions in such a series,

was to obtain a writing-down allowance determined without regard to section 109 (writing-down allowances at 10%) in respect of expenditure incurred by any person on the provision of the ship or aircraft.

340.In general terms (and disregarding for the moment the points on statutory construction advanced by the Appellant which are the subject of Issue 3) the purpose of section 123(4) CAA 2001 is (in the present case) to deny a person who has incurred capital expenditure on a ship the right to claim capital allowances even if he has satisfied the requirements of section 123(1) CAA 2001 (and has therefore shown that the ship is used for a "qualifying purpose"). This is so if the main object, or one of the main objects, of relevant transactions was to obtain a writing-down allowance. The substantive question of whether or not the Appellant is denied allowances by reason of the "main object" test is Issue 4 between the parties.

341.However, the Appellant first argues that that substantive question is never asked, because of the way in which the closing words of section 123(4) CAA 2001 are drafted. The Appellant argues that in its circumstances, if it does not show "a qualifying purpose", it is within the scope of section 110 CAA 2001 (which denies a right to all allowances) and not within the scope of section 109 CAA 2001 (which reduces the amount qualifying for allowances from 25 per cent to 10 per cent), and therefore it can never be said to have a main object of obtaining " a writing-down allowance determined without regard to section 109 …in respect of expenditure incurred on the provision of" the Vessels.

342.The Commissioners argue that the Appellant's construction cannot be supported on the grounds of the legislative history of the provisions in question, the logic of the language in section 123(4) CAA 2001, or policy. They argue that section 123(4) CAA 2001 is an anti-avoidance provision, and it would be absurd if it applied in circumstances where, under the "qualifying purpose" rules, a taxpayer would claim 10 per cent (rather than 25 per cent) writing-down allowances, but not in the more "offensive" cases where his circumstances would preclude him from claiming any allowances whatsoever.

343.Both parties sought to rely on the rather complex legislative history of what is now section 123(4) CAA 2001 and related provisions. We have outlined in paragraphs 9 to 14 above the legislative history of the "qualifying purpose" provisions as they relate to ships let on charter. The provisions of CAA 2001 are a product of the Tax Re-write project, but in relation to section 123(4) CAA 2001 there is nothing in the Explanatory Notes issued with the legislation to suggest that any change in the law was intended or thought to have been made by the re-write.

344.The immediate predecessor legislation is the consolidation statute, the Capital Allowances Act 1990. In that statute the provisions of section 123 CAA 2001 are

found in section 39 and the provisions of sections 109 and 110 CAA 2001 are found in section 42. Both parties made reference to those provisions, and it is helpful to set them out here.

345. The relevant parts of section 39 Capital Allowances Act 1990 are as follows:

> *(6)Without prejudice to subsections (1) to (5) above but subject to subsection (8) below, a ship is also used for a qualifying purpose at any time when it is let on charter in the course of a trade which consists of or includes operating ships if—*
>
> > *(a)the person carrying on the trade is resident in the United Kingdom or carries on the trade there, and*
> >
> > *(b)that person is responsible as principal (or appoints another person to be responsible in his stead) for navigating and managing the ship throughout the period of the charter and for defraying all expenses in connection with the ship throughout that period or substantially all such expenses other than those directly incidental to a particular voyage or to the employment of the ship during that period.*
>
> *(7)…..*
>
> *(8)Subsection (6) above does not apply if the main object, or one of the main objects, of the letting of the ship or aircraft on charter, or of a series of transactions of which the letting on charter was one, or of any of the transactions in such a series was to obtain—*
>
> > *(a)if the expenditure in question is old expenditure, a first-year allowance, or*
> >
> > *(b)if the expenditure in question is new expenditure, a writing-down allowance of an amount determined without regard to section 42(2),*
>
> *in respect of expenditure incurred on the provision of the ship or aircraft whether that expenditure was incurred by the person referred to in subsection (6)(a) above or some other person.*

346. The relevant parts of section 42 Capital Allowances Act 1990 are as follows:

> *(1)This section has effect with respect to expenditure on the provision of machinery or plant for leasing where the machinery or plant is at any time in the requisite period used for the purpose of being leased to a person who—*
>
> > *(a)is not resident in the United Kingdom, and*
> >
> > *(b)does not use the machinery or plant for the purposes of a trade carried on there or for earning profits or gains chargeable to tax by virtue of section 830(4) of the principal Act,*
>
> *and where the leasing is neither short-term leasing nor the leasing of a ship, aircraft or transport container which is used for a qualifying purpose by virtue of section 39(6) to (9).*

(2)In their application to expenditure falling within subsection (1) above, sections 24, 25 and 26 as they have effect—

(a)in accordance with section 41, or

…

shall have effect, subject to subsection (3) below, as if the reference in section 24(2) to 25 per cent. were a reference to 10 per cent.

(3)No balancing allowances or writing-down allowances shall be available in respect of expenditure falling within subsection (1) above if the circumstances are such that the machinery or plant in question is used otherwise than for a qualifying purpose and—

(a)…

(d) either the lease is expressed to be for a period which exceeds 13 years or there is, in the lease or in a separate agreement, provision for extending or renewing the lease or for the grant of a new lease so that, by virtue of that provision, the machinery or plant could be leased for a period which exceeds 13 years;

The Appellant's submissions

347.The Appellant's case was based on what Mr Peacock claimed was the natural reading of section 123(4) CAA 2001: it was common ground that the Appellant could never have claimed 10 per cent writing-down allowances within section 109 CAA 2001 if the leasing of the Vessels were not protected leasing; instead, because the lease period of the finance lease exceeded 13 years, if the Vessels were not used for a qualifying purpose, the Appellant would be within section 110 CAA 2001, which denies it a right to claim any allowances. It could therefore never be said that in entering into the relevant transactions it was a main object "to obtain a writing-down allowance determined without regard to section 109". In particular, section 123(4) CAA 2001 is not phrased, as the Commissioners wish to apply it, in terms of whether a main object of entering into the transactions in question was to ensure that the ship is used for a qualifying purpose by satisfying the conditions of section 123(1) CAA 2001.

348.In looking at the legislative history of these provisions it is necessary to bear in mind that sections 109 and 110 CAA 2001 reflect two related but distinct mischiefs. First, where assets were leased to a non-resident lessee (who would otherwise derive benefit from the 25 per cent writing-down allowances available to the lessor) allowances were reduced to the rate of 10 per cent broadly to align the allowances to the stream of rental received by the lessor: this was effected by provisions which are now section 109 CAA 2001. Secondly, and distinctly, when attempts were made to avoid that alignment of allowances to rentals by using leases to non-residents with extended lease periods or variable lease rental profiles, all allowances were denied: this was effected by provisions which are now section 110 CAA 2001. The "main objects" restriction in the case of ships let on charter originally applied to first-year allowances, and when it was applied to writing-down allowances on the abolition of first-year allowances it related specifically to section 70(2) Finance Act 1982, which

was the provision dealing with the reduction in the rate of allowances from 25 per cent to 10 per cent. This is followed through into the terms of section 123(4) CAA 2001.

349.Given that section 123(4) CAA 2001, with its specific reference to section 109 CAA 2001, has a purpose in its own terms (that is, where the circumstances are such that the lessor could claim 10 per cent rather than 25 per cent writing-down allowances), it is not open to the tribunal to construe it as though there were also specific reference to section 110 CAA 2001. Thus even if the eventual conclusion is that there is an oversight in not bringing the circumstances of nil allowances within the scope of the anti-avoidance provision, it is for Parliament, and not the courts, to remedy matters – the tribunal must apply the provision in accordance with its terms.

The Commissioners' submissions

350.Mr Ewart, in his survey of the "archaeology" of these provisions, looked primarily to the immediate predecessor provisions in the consolidation statute, the Capital Allowances Act 1990. He argued that it was legitimate to do so since there was no intention, in the Tax Re-write comprising CAA 2001, to change the law.

351.He pointed out that the structure of section 42 Capital Allowances Act 1990 is to provide cumulative conditions in subsections (1) to (3), which was recognised in the decision of the Court of Appeal in the case *BMBF (No 24) Ltd v Commissioners of Inland Revenue* 79 TC 352. The failure of the conditions in subsection (1) leads to allowances being given at the 10 per cent rate rather than the 25 per cent rate (as provided in subsection (2)). That subsection is expressly subject to subsection (3), which provides that no allowances are available when the lease has any of the specified "offensive" terms. By this means subsections (1) and (2) are stepping stones to subsection (3) – if the taxpayer's expenditure is on a ship and it is not used for a qualifying purpose within section 39(6) (i.e. not let on a time charter by a UK operator) then subsection (2) applies to reduce the allowances to 10 per cent, but if the lease has "offensive" terms, subsection (3) applies to reduce the allowances further to nil.

352.Section 42(1) Capital Allowances Act 1990 includes the condition (by its reference to section 39(6) Capital Allowances Act 1990) that the ship is used for a qualifying purpose by reason of being let on time charter by a UK operator. Therefore, when section 39(8) Capital Allowances Act 1990 (the predecessor provision of section 123(4) CAA 2001) makes reference to a main object of a transaction being to obtain "a writing-down allowance of an amount determined without regard to section 42(2)", that implicitly incorporated a reference to a claim for a writing-down allowance on the grounds that the ship was being used for a qualifying purpose, regardless of whether (were there no qualifying purpose) allowances would have been available at 10 per cent or no allowances would have been available.

353.In this way the Capital Allowances Act 1990 provisions give the only logical result, that the "main object" anti-avoidance provision applies (if the "main object" test is satisfied) regardless of whether the lessor would have claimed 10 per cent

allowances or no allowances if he were unable to satisfy the condition that the leasing was a "qualifying purpose". In the Tax Re-write what was section 42 Capital Allowances Act 1990 has been divided into individual sections (sections 109 and 110 CAA 2001), and the cumulative and interdependent nature of the conditions within the different subsections of section 42 Capital Allowances Act 1990 has been lost in the process – instead, the conditions are set out independently in each of sections 109 and 110 CAA 2001.

354. The Commissioners rejected the Appellant's argument that the "separateness" of sections 109 and 110 CAA 2001 reflect two distinct "mischiefs": there was only one "mischief", namely leasing to an overseas lessee where the benefit of the allowances was being "exported" from the UK, and the refinement of nil allowances (rather than 10 per cent allowances) was introduced when the benefit of allowances was still being "exported" by means of delayed rents through extended lease periods or variable rent payment terms.

355. In all these circumstances section 123(4) CAA 2001 should be construed to give effect to the provisions as they originally had effect, and to give a sensible result having regard to the scheme of the legislation.

Discussion

356. As discussed, the narrow point of dispute between the parties is the significance, in section 123(4) CAA 2001, of the phrase "determined without regard to section 109 (writing-down allowances at 10 per cent)". Both parties agree that the Appellant is not in a position to claim allowances at 10 per cent under section 109 CAA 2001 because the term of the lease exceeds 13 years. Instead, (and prospectively) the Appellant's circumstances bring it within section 110 CAA 2001 so as to disentitle the Appellant from claiming any writing-down allowances whatsoever if the leasing is not protected leasing. Therefore the Appellant is either entitled to 25 per cent allowances on its expenditure on the provision of the Vessels (if it meets the "qualifying purpose" conditions of section 123(1) CAA 2001, and that provision is not disapplied by the "main objects" provision of section 123(4) CAA 2001) or it is entitled to no allowances (either because it fails to meet the "qualifying purpose" conditions of section 123(1) CAA 2001, or it meets those conditions, but section 123(1) CAA 2001 is disapplied by the operation of section 123(4) CAA 2001).

357. Mr Ewart submitted that the position which the Appellant was contending for is absurd, and we agree with that. There can be no grounds of logic or policy (and certainly none which Mr Peacock could identify to us) to limit the application of the "main objects" anti-avoidance provision to the circumstances where the taxpayer's claim (if he is unable to show a "qualifying purpose") is to 10 per cent allowances and to let the more "mischievous" taxpayer (who is denied all allowances if he is unable to show a "qualifying purpose") escape its clutches. Mr Peacock's final shot was that Parliament had got it wrong, but we find that an unattractive approach in the case of legislation which has been, in one guise or another, in operation since 1982.

358.In construing and applying section 123(4) CAA 2001 we consider that it is legitimate to have regard to the corresponding provisions in the Capital Allowances Act 1990, particularly where there is an apparent absurdity, and where that appears to have arisen from the Tax Re-write project, and where (as the parties agreed was the case) there was no intention to change the law.

359.Those provisions, sections 39 and 42 Capital Allowances Act 1990, are themselves not (with regard to the point presently under consideration) a model of clarity. They are the result of piecemeal amendment over a number of years between 1982 and 1986 to accommodate major structural changes to the capital allowances regime and to thwart the ingenuity of the equipment leasing industry as it sought to circumvent or diminish the effect of stricter conditions under which capital allowances could be claimed in the context of leasing transactions. Thus it is the case that the provision which is now section 123(4) CAA 2001 has its origins in denying a taxpayer first-year allowances, and that original provision was adapted to apply to overseas leasing as that came to the fore following the phasing out of first-year allowances.

360.By reference to the provisions in the Capital Allowances Act 1990 we were persuaded by the analysis put forward by Mr Ewart for the Commissioners. We have set that out in some detail above. The essence of his case as to the construction of section 39(8) and section 42 Capital Allowances Act 1990 was that subsections (1), (2) and (3) of section 42 are linked, in that they are cumulative, a proposition which finds support in the *BMBF (No 24) Ltd* case. The first question is whether the expenditure falls within section 42(1), that is, is it expenditure on the provision of machinery or plant for overseas leasing where the leasing is not of a ship used for a qualifying purpose within section 39. If that is the case, section 42(2) applies to reduce writing-down allowances for the expenditure within section 42(1) from 25 per cent to 10 per cent, but that is subject to section 42(3), which denies all allowances for expenditure within section 42(1) if the lease has "offensive" terms.

361.Turning to section 39 Capital Allowances Act 1990, a ship is used for a qualifying purpose if it is let on a time charter by a UK-based operator (section 39(6)), and if that is the case the expenditure on the ship is not expenditure to which section 42(1) applies (and so neither sections 42(2) nor 42(3) come into play). But if there is a "main object" of obtaining a writing-down allowance, section 39(8) disapplies section 39(6), so that the expenditure falls within section 42(1) (the ship is not used for a qualifying purpose), which in turn requires that section 42(2) is applied, and it has effect subject to section 42(3) if the lease terms so require. The reference to "a writing-down allowance of an amount determined without regard to section 42(2)" in section 39(8) is not to be seen as limiting the operation of section 39(8) to the situation where 10 per cent allowances are available, but, because of the inter-related subsections of section 42, to the situation where there is expenditure which falls within subsection (1) of section 42 (which is expenditure which may qualify for 10 per cent allowances or nil allowances as subsection (2) has effect, including where it has effect subject to subsection (3)).

362. In the course of re-writing these provisions as they appear in CAA 2001, sections 109 and 110 CAA 2001 have been "disconnected" – effectively each is made to stand alone, which has had the apparent consequence (unintended, since there was no purpose to change the law) of giving the reference to section 109 CAA 2001 in section 123(4) CAA 2001 a limiting significance which is not found in the corresponding reference to section 42(2) Capital Allowances Act 1990 in section 39(8) Capital Allowances Act 1990.

363. We consider that we should construe section 123(4) CAA 2001 having regard to the provisions of which it is a re-statement, so that the reference to section 109 CAA 2001 does not have the limiting or restricting effect which on its face it has. That gives a sensible result which accords with the scheme of the legislation.

364. We can arrive at the same conclusion by a different, and equally valid, route. The expression we are concerned with is "determined without regard to section 109". The phrase "without regard to" means "without taking into account", or "without heed to" the matter in question. If no account is to be taken of the position under section 109 CAA 2001, it does no matter whether section 109 could or could not apply in this context, because it is immaterial. If what the taxpayer sought to obtain was a 25 per cent writing-down allowance then that does not involve an allowance that is determined under section 109 CAA 2001 – section 109 CAA 2001 is not in point. If section 109 CAA 2001 is not in point either because it could not apply or because it could only apply if 25 per cent allowances were not available, then the exercise of determining whether or not the taxpayer sought to obtain a 25 per cent writing-down allowance can be carried out without regard to section 109 CAA 2001.

365. Therefore for this further reason the reference in section 123(4) CAA 2001 to section 109 CAA 2001 should not be read as having the limiting effect for which the Appellant contends.

366. For these various reasons, therefore, we conclude that section 123(4) CAA 2001 can apply in the circumstances where section 110 (rather than section 109) CAA 2001 is in point, and can therefore in principle apply to the circumstances of the Appellant's claim for writing-down allowances for its expenditure on the provision of the Vessels.

367. Accordingly, we decide Issue 3 in the Commissioners' favour.

Issue 4: if Issue 3 is determined so that in principle section 123(4) CAA 2001 applies, was the main object, or one of the main objects, of any transaction or series of transactions which includes the letting of the Vessels on charter to obtain the 25 per cent writing-down allowances claimed by the Appellant?

368. Having concluded, as a matter of the proper statutory construction of section 123(4) CAA 2001, that in principle it can apply in the circumstances of the Appellant, we have to decide whether on the facts of the case it does so apply so as to deny the Appellant the right to the 25 per cent writing-down allowances it has claimed in relation to its expenditure on the Vessels.

369. As mentioned, section 123(4) CAA 2001 has to be considered if the Appellant has demonstrated that the Vessels are used for a "qualifying purpose" by satisfying the requirements of section 123(1) CAA 2001 (in the present case, if it succeeds in Issue 1 and Issue 2) – section 123(4) CAA 2001 is the final hurdle it needs to surmount.

370. The question we have to determine is whether the main object, or one of the main objects, of the letting of the Vessels on charter, or of a series of transactions of which the letting of the Vessels on charter was one, or of any of the transactions in such a series, was to obtain the 25 per cent writing-down allowances claimed by the Appellant in respect of its expenditure on the provision of the Vessels. If that is the case, the writing-down allowances cannot be claimed.

371. The Appellant's case, in summary, is that the provisions of section 123(4) CAA 2001 must be applied so as to accord with their context and the reasons for which they were enacted: capital allowances provide an incentive to investment with special protection for shipping businesses genuinely carried on in the UK, and an anti-avoidance test should not be construed so as to negate the purpose of the incentive. Each of the transactions in the leasing and chartering arrangements has a real and significant commercial purpose for the parties concerned, and although it is undeniable that the parties sought to ensure that capital allowances would be available, that was subservient to the main object of the transactions, which was to meet the commercial objectives which the different parties had.

372. The Commissioners identified the grant of the bareboat charter and the novation of the time charter to K-Euro (thus, the interpositioning of K-Euro into the leasing structure) as the transactions in the series of leasing transactions which had as their main object, or as one of their main objects, the obtaining of the allowances. These transactions, they say, were entered into only after K-Line had taken advice as to what steps had to be taken to enable capital allowances to be claimed through a UK finance lease structure, and were not motivated by commercial requirements or undertaken to pursue a commercial purpose: the commercial objectives of the parties could have been achieved without K-Euro becoming the disponent owner of the Vessels by means of these transactions.

The Appellant's submissions

373. Mr Peacock explained that what is now section 123(4) CAA 2001 had been introduced by section 71 Finance Act 1982 (in the context of the 100 per cent first-year allowances regime) in order to narrow the scope of what is now section 123(1) CAA 2001. The relevant Finance Bill debates, to which he referred us, show that the government considered that the concession which had been made in previous legislation (in the Finance Act 1980) to preserve first-year allowances for UK companies chartering ships to overseas charterers (which would otherwise have been subject to the rules restricting allowances under the "overseas leasing" provisions) was being exploited by the use of "brass plate" chartering companies in the UK. The "main object" anti-avoidance provision was introduced to deny allowances in such cases, but Treasury ministers repeatedly stressed that they wished to safeguard the

right to first-year allowances in cases where ships were chartered to overseas lessees by companies carrying on a genuine shipping business in the UK (and where there would be benefit to the UK in the form of taxable profits from such business), and that the provisions would be operated with that intention. Mr Peacock argued that we should construe and apply section 123(4) CAA 2001 with that purpose and context in mind.

374. Mr Peacock submitted that the proper approach to applying section 123(4) CAA 2001 is to consider the transaction or series of transactions of which it is asserted that the main object is obtaining the allowances, and to assess the objects of such transactions at the time they were entered into. So far as the language of the statute permits, the provision should be interpreted to take account of the purpose of the statute (both the abuse at which it was directed and the beneficial use which is to be safeguarded), and it should not be applied so as to frustrate the incentive specifically created and preserved for those cases which fall outside the mischief at which the provision is directed. In ascertaining whether an object of a transaction or series of transactions is a "main object" it is necessary to attribute weight to those matters which can fairly be regarded as the objects of the transaction or transactions (the achievement of one or more commercial purposes, the obtaining of allowances, etc) so as to establish a priority of such objects.

375.In encouraging us to adopt this approach, Mr Peacock referred us to the cases of *Commissioners of Inland Revenue v Brebner* [1967] 2 AC 18 and *Barclays Mercantile Industrial Finance Limited v Melluish (Inspector of Taxes)* [1990] STC 314, both being cases where the courts were concerned with anti-avoidance provisions based upon whether the obtaining of a tax benefit was the main purpose or object of transactions or other arrangements.

376.In the *Brebner* case it is made clear (see Lord Upjohn at p 30) that where a taxpayer carrying out a commercial transaction has the choice in deciding how to structure his transaction, it should not necessarily be inferred when considering whether he is within the scope of a tax anti-avoidance provision that if he chooses the structure that is the more tax efficient (that is, results in his paying less tax) then one of his main objects is to avoid tax: "No commercial man in his senses is going to carry out a commercial transaction except upon the footing of paying the smallest amount of tax that he can."

377.The *Barclays Mercantile* case shows that if the taxpayer claiming capital allowances is engaged in a commercial transaction where the allowances are nevertheless a significant factor in rendering that transaction commercially viable, obtaining the allowances is not a main purpose of the transaction.

378.Mr Peacock then proceeded to review each of the transactions in the leasing chain in the Appellant's case, arguing that in each transaction there was a genuine commercial objective for the parties in entering into that particular transaction, whether to earn profits, share commercial risk, pursue a business strategy, or ensure reliable and long-term transport facilities for the gas products of the Snøhvit project. If one looked at the transactions as a whole, the only objective is the entirely

commercial one of acquiring ships with appropriate financing and making them available on commercial terms to transport LNG from supplier to customer. All parties were alive to the benefits to be derived from the cheaper financing of the Vessels by reason of the capital allowances, and most parties, in different degrees, derived advantage from those benefits. They therefore sought advice to ensure that they met the conditions upon which the capital allowances, and the benefits which they offered, were dependant. That is not to say, however, that it was a main object of any of the transactions (or of some or all of the transactions taken together) to obtain those capital allowances – the Appellant argues that it is not an object at all of the transactions. The only objects – and certainly the only ones which could be described as main objects – of the parties in entering into the transactions were to achieve their respective commercial purposes.

379. With particular regard to the participation of K-Euro in the transactions, (taking the hire of the Vessels under the bareboat charter and chartering them to the Snøhvit Sellers by the time charter novated to it), the evidence established that K-Euro was an established UK shipping company whose business was being developed in pursuit of a wider strategy which the K-Line group was implementing. Its activity as disponent owner chartering the Vessels was in furtherance of those business objectives. It was far removed from the "brass plate" companies at which the "main object" provisions of section 123(4) CAA 2001 were directed.

The Commissioners' submissions

380. It is the Commissioners' case that it was the main object, or one of the main objects, of at least two of the transactions in the series of transactions comprising the letting of the Vessels on charter to obtain writing-down allowances for the Appellant's expenditure on the Vessels. Those two transactions, entered into in September 2002, were the grant of the bareboat charter by Northern LNG to K-Euro and the novation of the time charter to K-Euro, that is, the transactions whereby K-Euro became the disponent owner of the Vessels and let them on charter to the Snøhvit Sellers. Those transactions were undertaken so that the Appellant could claim that the terms of section 123(1) CAA 2001 were satisfied and the Vessels accordingly used for a "qualifying purpose".

381. Mr Ewart dismissed the Appellant's attempts to give scope to the meaning and application of section 123(4) CAA 2001 by reference to ministerial statements and Inland Revenue press releases: the section is clear, and not ambiguous, in its meaning and must be construed in the normal way. In any event, he argued, the situations referred to in the ministerial statements, with their emphasis on genuine UK shipping businesses, are far removed from the circumstances of K-Euro.

382. Mr Ewart and Mr Cooper referred to the evidence in support of their case that it was at least a main object of the transactions they had identified that 25 per cent writing-down allowances should be available to the Appellant. We have already mentioned their respective submissions as to the lack of commerciality in the charter-party arrangements and in K-Euro's position as disponent owner. Mr Ewart drew our attention to the following additional points:

(1) Whilst it was clear that the Snøhvit Sellers required that the Vessels should be managed by someone in the European time zone, it was not their requirement that the owner or operator of the Vessels should be located in Europe – that step was taken by K-Line only at the later stage when it realised (having taken advice) that it was necessary in order to obtain UK tax-based lease finance for the Vessels;

(2) K-Line could offer no commercial justification or advantage for inserting K-Euro into the lease structure as disponent owner – any commercial objectives it had to develop the bulk and gas business in Europe could have been achieved without K-Euro acting as disponent owner in this particular transaction: that was demonstrated by the 2006 reorganisation (which separated out all the other business) and by the fact that, in relation to other vessels operated in the European time zone, K-Euro did not act as disponent owner;

(3) Similarly, the Appellant's claim that it was a primary object of bringing in K-Euro that it had an "owner's" relationship with the time charterers does not stand up to scrutiny in view of the other shipping transactions where K-Euro acted as manager and in view of the restructuring of K-Euro's business in the 2006 reorganisation – and in any event it is not such a significant factor that it displaces, as a main object, the aim of obtaining the capital allowances in the financing arrangements;

(4) The true commercial deal was represented by the arrangements documented in December 2001 with K-Line (and the other parties it wished to bring in as co-owners of the Vessels) chartering the Vessels to the Snøhvit Sellers on the terms of the time charter – everything which happened subsequently in terms of the structure was designed (following detailed and specific advice from specialist UK tax and financial advisers) to achieve the requirements of the financing (including the availability of UK capital allowances) whilst not disturbing the commercial deal already in place; and

(5) K-Euro played the role of a disponent owner for the sake of the allowances, but the commercial reality was that K-Euro was always seen as a manager, with limited exposure to risk and a profit based on a mark-up on its costs (that profit being determined upon advice as to what would be acceptable for establishing a "bona fide shipping company"). It was the understanding of the Snøhvit Sponsors that they – as the real owners of the Vessels – would bear the risks and benefits derived from the operation of the Vessels, as was eventually shown to be the case with the 2006 reorganisation.

383. Mr Ewart submitted that, in ascertaining the main objects of the relevant transactions it is necessary to look individually at the objects or purposes of the parties entering into those transactions. In the case of Northern LNG (looking to its shareholders, the Snøhvit Sponsors), their objective in entering into the bareboat charter could only have been to secure cheaper finance for the Vessels through a tax-based lease, that is, to ensure that the requirements of section 123(1) CAA 2001 were satisfied: they could show no commercial objective beyond that. In the case of K-Euro itself, it acted upon the direction of K-Line and therefore had little or no independent objective, but in so far as it had, it was aligned with the objectives of K-

Line, and for the reasons given, those objectives were substantially to ensure that the requirements of section 123(1) CAA 2001 were satisfied. As for the Snøhvit Sellers, their only objective in accepting the novation of the time charter to K-Euro was to maintain the commercial terms of the time charter which they had negotiated in 2001.

384. The conclusion therefore was that, taking all points of view, it was at least one of the main objects of the relevant transactions for the letting of the Vessels on charter that the terms of section 123(1) CAA 2001 should be met so that a 25 per cent writing-down allowance might be obtained in respect of the Appellant's expenditure incurred on the provision of the Vessels, and accordingly section 123(4) CAA 2001 applies to deny that outcome.

Discussion

385. In considering the meaning, scope and application of section 123(4) CAA 2001 we agree with Mr Ewart (who referred us to ***R v Secretary of State for the Environment, Transport and the Regions,*** ex parte *Spath Holme Ltd* [2001] 2 AC 349) that the language of the provision is not ambiguous or obscure in its meaning. We also agree that the ministerial comments on this provision (or, rather, its previous incarnation), made in the course of the relevant Finance Bill committee stage debates, do not comprise a clear and unequivocal statement addressing the circumstances of the Appellant (or K-Euro). We therefore take no account of those statements in considering the application of the provision to the circumstances of this case.

386. We agree with Mr Peacock that it is necessary to discern the meaning and scope of the provision in its context: in particular the context of a statutory regime whose purpose is to encourage taxpayers to make capital expenditure on certain assets (including ships) in certain circumstances. In this respect the provision differs from other "main object" or anti-avoidance provisions in the tax code aimed at denying the taxpayer a tax advantage (such as utilising a tax loss, or claiming a deduction) which might otherwise be available to him. Section 123(4) CAA 2001 cannot have been intended to emasculate the incentives available through the capital allowances legislation by reason of section 123(1) CAA 2001.

387. An incentive, by its nature, is designed to influence behaviour – to encourage a person to choose a particular course of action he might otherwise not have chosen to take. To an extent (and that extent will vary according to the circumstances of the person concerned) the obtaining of that incentive will be a motive for the course of action chosen. In some situations the incentive will be the prime motive, as where a taxpayer would not have made a particular capital investment without the benefits provided by capital allowances. In other situations the incentive will shape a transaction, rather than bring it about, as where a taxpayer intends, entirely for commercial reasons, to make a capital investment, and chooses to structure it one way rather than another so that capital allowances are available to him or to another person who can take the immediate benefit of those allowances. In yet other situations a taxpayer will make a capital investment entirely for commercial reasons, and the capital allowances will be a welcome, but incidental, benefit, perhaps influencing marginally the timing of the investment, but nothing more. There is a wide spectrum

here, and every taxpayer's circumstances will place him at a particular point in that spectrum. Section 123(4) CAA 2001 must be applied with these factors in mind.

388.We consider, therefore, that it is not fatal to a taxpayer's claim to capital allowances, where that claim is based on section 123(1) CAA 2001, that the taxpayer has taken steps which seek to secure or bolster his likelihood of obtaining those allowances. The question which has to be answered is whether a main object of the relevant transactions was the obtaining of those allowances, and this envisages that there may be a range of objectives motivating the transactions, and that they must be assessed in some sort of priority or hierarchy and then some basis applied to separate those which are of sufficient significance to count as "main" from those which are not. The issue is then which side of the line falls any objective of obtaining the allowances.

389.In the present case the parties focused on the commerciality of the transactions, and in particular those which directly involved K-Euro. The Appellant argued that the arrangements put in place – in their overall scope and in their particular detail – were in pursuance of a strategic commercial ambition, and that should be seen as the prime motivation of the relevant parties. At his boldest, Mr Peacock argued that the availability of the capital allowances was merely a welcome and incidental consequence of the transaction, albeit one in respect of which the parties had taken expert advice to ensure that it would indeed follow. The Commissioners argued that the key transactions – those which brought about the involvement of K-Euro – lacked any commercial justification and therefore would not have been undertaken but for the capital allowances which the parties hoped to obtain for their various benefits.

390.We agree that in determining the objectives of the transactions, and ranking those objectives, a key factor – perhaps the key factor – is the commercial basis or justification for entering into those transactions, or, perhaps, the commercial purpose which is served for the parties in entering into those transactions. It will throw light on what the true objectives are and what their relative significance is if there is a range of objectives.

391.This was the approach of the court in the case of *Barclays Mercantile Industrial Finance Ltd v Melluish (Inspector of Taxes)*, to which Mr Peacock referred us. The case concerns a finance lessor's claim for 100 per cent first-year capital allowances in respect of its expenditure on the acquisition of two films which it acquired from its lessee in a sale and lease-back financing transaction. In order to claim successfully the allowances in the particular circumstances of the case the taxpayer finance lessor had to satisfy a "main object" test similar to that faced by the Appellant in this case. In the *Barclays Mercantile* case the relevant provision (what was then paragraph 3(1)(c), Schedule 8 Finance Act 1971) was as follows:

> Where a person incurs capital expenditure on the provision by purchase of machinery or plant which has been in use for the purposes of a trade carried on by the seller, and…it appears with respect to the sale, or with respect to transactions of which the sale is one, that the sole or main benefit which, but for this sub-paragraph, might have been expected to accrue to the parties or any of them was obtaining of [a

> first-year allowance], a first-year allowance shall not be made in respect of the expenditure….

Both the Special Commissioners and Vinelott J accepted the taxpayer's submission that its main object was to make a profit by acquiring and leasing the film, and this was so even though it was probable that it would not have been in a position to offer a lease on acceptable terms had it not been able to obtain and utilise the first-year allowances. Vinelott J went further, stating: "Paragraph (c) as I see it is aimed at artificial transactions designed wholly or primarily at creating a tax allowance."

392. Before looking at the commercial basis or justification of the relevant transactions, section 123(4) CAA 2001 requires us to identify the transaction or transactions which (in shorthand) are tax-motivated. The Commissioners, in seeking to deny the Appellant's claim for writing-down allowances, contend that the grant of the bareboat charter of the Vessels by Northern LNG to K-Euro and the novation to K-Euro of the time charter of the Vessels are transactions in a series of transactions of which the letting of the Vessels on charter was one, and, of course, they further contend that the main object, or one of the main objects, of those transactions was to obtain the writing-down allowances in question. The Appellant does not deny that those transactions were transactions in a series of transactions of which the letting of the Vessels was one.

393. Those transactions were entered into on 19 September 2002, when the finance lease and related documents were also entered into. It should be noted, however, that they were in contemplation at what is described in the Statement of Agreed Facts as "the Preliminary Stage", that is, at the time (19 December 2001) K-Line entered into the Shipbuilding Contract and granted the time charter to the Snøhvit Sellers. The Memorandum of Understanding which Statoil (on behalf of the Snøhvit Sellers) signed with K-Line on that date anticipates not just that K-Line will seek to finance the purchase of the Vessels by means of a UK finance lease or some other form of financing (with a consortium company having the economic equity interest in the Vessels), but that the Vessels will be operated by a company carrying on business as ship operator in the UK, for which purpose the consortium company will grant a bareboat charter and the time charter will be novated.

394. The significance of this is that there was an element of the case argued by the Commissioners that the transactions documented in December 2001 (the Shipbuilding Contract and the time charter) comprised the "real" commercial deal struck between the K-Line group and the Snøhvit Sellers, and that the insertion of K-Euro into the structure in September 2002 was a later arrangement conceived once K-Line understood what needed to be done in order for capital allowances to be available in the course of the financing of the Vessels. That view cannot be sustained in the light of the Memorandum of Understanding. The entirety of the structure, as it stood following the 19 September 2002 documentation, was the aim of the parties in December 2001, and their commercial (or other) purpose in entering into the relevant transactions should be viewed with this in mind.

395. This is so notwithstanding that K-Euro is not a party to the Memorandum of Understanding and that it is not identified as the ship operating company referred to in

that document. It is no more than the application of routine commercial reality to ascribe to individual members of a group of companies the objectives of the group as a whole (or, rather, that part of the wider group engaged upon the same endeavour) unless the evidence shows otherwise. K-Euro's objectives (in so far as in themselves they are relevant to ascertain the objectives of the transactions to which it was a party) should therefore be viewed in the light of the K-Line group's objectives as well as with regard to its own actions and the decisions of its directors – and its directors acting commercially will have regard to group policy and objectives.

396.Having identified the transactions to which the "main object" test must be applied, the question arises as to the time at which that test falls to be applied. In the normal case of a transaction entered into (that is, documents signed and delivered) and its terms executed shortly thereafter, the objects of the transaction are judged by reference to the circumstances, actions and motives of the parties at the time they enter into the transaction (including their circumstances, actions and motives as they are apparent from the terms or effect of the transaction). In the present case the execution of the terms of the transaction documents (that is, the letting of the Vessels on charter) did not begin to be carried out until delivery of the Vessels some years after those documents were entered into – and by which time the circumstances of a key party – K-Euro – had very significantly changed first by reason of the development of its business and then by the 2006 reorganisation of that business. Nevertheless, it would seem that the objects of the transactions we are concerned with should be ascertained as at the time that the documents effecting them were entered into – later events are relevant only if and to the extent that they can be shown to shed light on the parties' purposes or aims at that earlier time (as might be the case, for example, where the later events were in contemplation or were foreseeable at that earlier time).

397.In the present case we have the further complication that the transactions in question, although entered into in September 2002, were in clear contemplation in December 2001, although not necessarily at that time in the contemplation of K-Euro itself (indeed, the evidence is that K-Euro had some reluctance to involve itself in the tender process which resulted in the December 2001 documentation). Further, plans and objectives could have changed up until the moment the relevant transaction documents were entered into, but since the scope and general effect (but not the detailed terms) of the transactions documented in September 2002 were a matter of formalised and documented intent in December 2001, that would seem to be a key point at which to ascertain the objects of the relevant transactions – but taking account of subsequent matters in the period until 19 September 2002 (including the actual terms of the documents then entered into) which may show an influence upon the parties' objectives.

398.We turn now to ascertaining the objects of the identified transactions on the basis of the evidence before us.

399.We have already drawn some conclusions as to the commerciality of K-Euro's activities when considering, for the purposes of deciding Issue 2, whether it was letting the Vessels on charter in the course of a trade. We take those conclusions into

account also in looking to the aims of the relevant transactions for the purposes of deciding whether or not section 123(4) CAA 2001 should apply.

400.Mr Aoki's evidence was most pertinent to this issue. We have set out Mr Aoki's position and his role in the K-Line group's involvement in the Snøhvit project at paragraph 108 above. He was well placed to speak of the aims of that group and of the reasons why group companies entered into the transactions with which we are concerned. As we have said, he was a convincing witness, and we accept his evidence.

401.Taking the broader picture first, it is clear that the K-Line group's decision to acquire and let the Vessels on the terms of the time charter as specified by the Snøhvit Sellers was taken in order to pursue the group's business strategy of expanding its business (specifically, it gas and bulk carrier business) into the Atlantic Basin: it had a leading position in such business (including in respect of LNG carriers) in the regions described to us as East of Suez which gave it the standing to make that step, which the Snøhvit Sellers recognised by accepting its tender. K-Line saw the Snøhvit project as a high-profile operation, commercially valuable in itself and with the further value that it would give the K-Line group substance and credibility in the market in which it intended to develop its business. The broad objective, therefore, of letting the Vessels on charter was entirely to achieve a particular commercial aim.

402.Concurrently the K-Line group had the strategy of devolving business away from its main business centre in Japan to regional centres in order to develop relationships with customers at local level and to be more immediate in responding to their requirements. In this regard the Snøhvit project also offered the K-Line group the opportunity to pursue that strategy, since it was a requirement of the Snøhvit Sellers that at least the management of the Vessels for their benefit as time charterers should be carried out within the European time zone. (In his oral evidence Mr Thomassen explained that there was also a preference for the Vessels to be operated by a party with an ownership interest in the Vessels, rather then "externally" managed, since in his experience more care was given to the proper running of a vessel if the person managing it had a stake in the vessel's well-being.)

403.The K-Line group identified K-Euro as the entity within the group which would comprise its regional centre and which would develop its bulk and gas carrier business in the Atlantic Basin. The Snøhvit project was an opportunity to pursue those aims, and to do so by the participation of K-Euro in that project. As we have mentioned, K-Euro had an established presence in the UK and European coastal shipping market (but not in respect of bulk and gas carriers operating in the Atlantic Basin), and it was the natural choice of entity through which the K-Line group could realise its plans generally and specifically in respect of its involvement in the Snøhvit project.

404.It was recognised, by both K-Euro itself and by the K-Line group, that if it were to achieve all the ambitions which the group had for it, and if it were to operate (or even manage) the Vessels as required, then it would have to increase very significantly its capability. As we have described, this is what it did, and as a result it

developed a significant business operating and managing bulk and gas carriers based in, or operating to and from, the Atlantic Basin. This development of K-Euro's business was largely carried out after September 2002, but the decisions to pursue that course, and the initial steps, were taken before September 2002, no doubt in part to convince the Snøhvit Sellers before the intentions of December 2001 became legal certainty in September 2002 that K-Euro would be in a position to operate the Vessels when they were delivered.

405. Mr Ewart sought to argue that once K-Line was made aware by its advisers of the need for K-Euro to be "a bona fide commercial UK shipping company" if the lease financing were to secure capital allowances, then it set about creating a business which would pass that test: its one real, or at least predominant, motive was to do what was thought necessary to ensure the allowances were available. We do not agree. That argument disregards the wider business aims of the K-Line group evident in its strategy, and it also disregards the commercial reality and substance of what actually happened. In the period up to the 2006 reorganisation K-Euro expanded its business in a genuine, methodical and commercial way and to a substantial extent. By the time of that reorganisation it had (in addition to the Vessels) nine bulk or gas carriers which it was operating or managing or which it was committed to operate or manage on their eventual delivery. To argue that such an enterprise was undertaken principally to give credence to a claim for capital allowances in relation to the Vessels is not sustainable.

406. Again, therefore, taking the broader view we conclude that K-Euro's participation in the chartering of the Vessels was undertaken in order to pursue commercial objectives by entering into commercial transactions which were the more commercially attractive in that they were indirectly funded by financings whose costs were reduced by the tax allowances taken elsewhere.

407. We need, however, to look at the nature of K-Euro's participation in these arrangements – a critical strand of the Commissioners' argument is that, whilst K-Euro's participation can be seen as meeting a requirement of the Snøhvit Sellers and therefore is commercially justified, it was not a requirement that it should be the disponent owner of the Vessels, and that requirement could have been met by appointing K-Euro as manager of the Vessels. They point to the fact that K-Euro, in expanding its business, took the manager's function in relation to other vessels, and that following the 2006 reorganisation its role in relation to the Vessels was little more than that of manager.

408. It is helpful to look first at the different interests in the Vessels. The Appellant has legal ownership of the Vessels, but, under the finance lease documentation, the economic ownership – or at least the equity in the Vessels – resides with Northern LNG. Northern LNG is a consortium company representing, in effect, the interests of its consortium member shareholders, the Snøhvit Sponsors (the proportions of their respective shareholdings differ as between the different Northern LNG companies for each Vessel, but nothing turns on that). With the exception of K-Line itself the Snøhvit Sponsors have no business involvement in operating LNG carriers: they have an investment interest in the equity in the Vessels. They were therefore not in a

position to operate the Vessels in order to hire them to the Snøhvit Sellers on the terms of the time charter. They could have engaged a ship manager to ensure that the Vessels were operated to meet the requirements of the time charter, but that would have left them with the operational and commercial risks of operating the Vessels. They passed on those risks to K-Euro by granting the bareboat charter so that it took on the risks of the disponent owner.

409.It is questionable whether it does in any event assist the Commissioners' case to say, in effect, "They could have done it differently", having regard to Lord Upjohn's comment in the *Brebner* case. But it is even less tenable to say, "They could have done it differently, notwithstanding that it would have given rise to different interests, risks and commercial consequences". Mr Ewart sought to deal with this by suggesting that a third party, or K-Line itself, could have been the disponent owner, contracting out the management of the Vessels to K-Euro so as to meet the "locally operated" requirement of the Snøhvit Sellers. The first response to this is to question why they should take that course of action when the commercial logic, in the context of the group's plans for its European business, was for K-Euro, rather than any other person, to take on this role.

410.Mr Aoki's evidence provided a different response to the Commissioners' contention on this point. He said that it is a common arrangement for the ownership (or economic ownership) of bulk and gas carriers to be held by a consortium (usually to ensure that the entirety of the ship and its financing is not on the balance sheet of any single owner). The K-Line group's preferred structure, where it is in such an arrangement, is to ensure that it has the role of operating the vessel, not only to enjoy the operator's profit, but to maintain the closest working relationship with the time charterers of the vessel, who are customers, or potential customers, across the K-Line group businesses. Where the other consortium members are competitor shipping lines, no one member will normally be permitted to take, additionally, the operator role in case that secures a competitive advantage over the other members, and in that situation a third party will be involved to operate the ship, sometimes on the basis that one or more consortium members provides management services. In relation to the Vessels, where there were no interests within the consortium competing with K-Line (the only other consortium member which was a shipping line did not operate LNG carriers), the group was able to adopt the preferred business structure by having K-Euro operate the Vessels as disponent owner taking the risks and (as intended) reaping the rewards.

411.The Commissioners point to the 2006 reorganisation to question whether in reality K-Euro had a genuine commercial role to justify its participation in the leasing structure. They refer to the fact that all its other business activities were stripped out and that it was in no position to fulfil a larger commercial purpose, but that it merely retained its contractual entitlements and obligations, and its obligations to operate the Vessels were contracted out to K-LNG under the Ship Management Agreement. It was, in consequence, a mere husk of a company with a single part-time employee whose role was limited to company and regulatory compliance matters. They argue that this demonstrates that the commercial justifications claimed for interposing K-Euro have little significance.

412. As we have said, the point at which one should judge the objects of transactions is the time they are entered into. Subsequent events may shed light on motives at an earlier time, especially if they were foreseeable at that earlier time. There is no evidence that K-Line, K-Euro or any of the other parties anticipated that such a reorganisation would be required – there could have been no purpose in putting in so much cost and effort to develop K-Euro's business if it had been anticipated that much of that business would have to be transferred elsewhere, with the consequent risk of damage to business relationships. Even if one were to accept the Commissioners' argument that such business was developed to give a cloak of commerciality to K-Euro's participation in the Snøhvit project, that would hardly have been undertaken if it had been foreseen that the contrivance would be dismantled before the Vessels had been delivered and the letting begun.

413. The principal reason for the 2006 reorganisation was the unexpected increase in the manning costs of the Vessels which it became apparent would leave K-Euro with substantial losses once it took delivery of the Vessels. There is also evidence that some of the constraints imposed by way of security arrangements were beginning to chafe on K-Euro's ambitions to develop its business. K-Line brought these matters to the attention of the Snøhvit Sponsors, who eventually accepted the need to take remedial action. There is nothing to suggest that that remedial action was in any way welcomed by K-Line or K-Euro: it was an act of expediency required to deal with a serious commercial threat.

414. In these circumstances we do not consider that the 2006 reorganisation throws any significant light back to the parties' intentions or motives at the time they entered into the relevant transactions. Nor does it call into question the commercial basis for adopting K-Euro in 2002 as the group company to develop the European bulk and gas carrier business. As mentioned, by the time of the 2006 reorganisation that business was substantial and well-developed. There was no evidence as to whether the business or any part of it was damaged by the reorganisation, but we can see that it may well have reached a state, in terms of customer relationships, market credibility and so forth where it was not put at serious risk by the reorganisation. That presumably was the calculation of the K-Line group management concerned, as they weighed up the need to solve the problems stemming from the anticipated losses in K-Euro from the operation of the Vessels against the risks consequent upon transferring the other businesses to other UK group companies. In these circumstances it is too facile to say that because K-Euro was not required for the European business in early 2006 it could not have been a serious commercial objective in early 2002 that it should be the lynch pin for the development of that business.

415. The Commissioners argue, as they did in relation to Issue 2, that K-Euro's role was not truly or commercially that of disponent owner, since it was always the intention – realised eventually in the 2006 reorganisation – that it should be protected by the Snøhvit Sponsors from the commercial risks of that role: accordingly, they argue, K-Euro was put in place in the structure principally to secure the availability of the capital allowances for the Appellant. We have dealt with this in part in the discussion above in relation to Issue 2, but since the Commissioners placed much

significance on the point in relation to section 123(4) CAA 2001 we need to consider their case here also.

416.There is nothing in the transaction documents themselves which supports this argument – K-Euro is exposed to the commercial risks of chartering the Vessels. It remains so exposed following the 2006 reorganisation, since the only action taken which impacts upon K-Euro itself in that reorganisation is the reduction, for a specified period, of the rent payable under the bareboat charter, and the increase in its share capital at the time of the reorganisation of its share capital, both designed to enable it to continue its activities.

417.The principal evidence which the Commissioners point to in support of their argument on this matter is a letter from a Mr Yasui, described as the General Manager of the LNG group of K-Line, to the Snøhvit Sponsors (other than K-Line) and dated 10 January 2003. It is headed "Snøhvit LNG Project: Proposal of Risk Allocation Scheme". It mentions that the Snøhvit Sponsors had the risks and benefits as co-owners of the Vessels until the grant of the bareboat charter, when K-Euro assumed certain of those risks (including the risk of the Vessels being off hire; the risks of operating expenses exceeding hire from the time charterers; and the credit risk of the time charterers). It notes that K-Euro must continue to bear those risks if it is to remain a "bona fide UK shipping company", and then makes a number of limited proposals for the removal of K-Euro from the leasing structure if there is insolvency of a time charterer, or if a Vessel is off hire for more than 180 days.

418.Mr Thomassen in his evidence said that Statoil and (he believed) the other addressee Snøhvit Sponsors had not replied to the letter. He said that the general intention had been that the Snøhvit Sponsors, as equity owners of the Vessels, would, as a general proposition, share in both the upside and the downside of the project, but that it was not until 2005 that it became apparent to all the parties that K-Euro's costs would significantly exceed the agreed hire paid for the Vessels by the Snøhvit Sellers. The Snøhvit Sponsors took the view that it was not in their long-term interests as equity owners of the Vessels that losses should continue to accrue in K-Euro in this way, since that put at risk the long-term flow of rental to them and to the finance lessor, and hence they agreed to reduce for a period the bareboat charter hire. They were by then prepared to participate as a consortium in the fortunes of K-Euro as regards its role as operator of the Vessels, and this was eventually achieved by the 2006 reorganisation, when they could take a proportionate shareholding (and increase proportionately K-Euro's share capital) once K-Euro's other businesses had been transferred out.

419.We do not consider that the letter from Mr Yasui has much bearing on this point. It confirms the change effected in September 2002, namely that the risks of owner/operator were then assumed by K-Euro, and recognises that the entitlement to allowances may be jeopardised if K-Euro is relieved of those risks. The proposals made (none of which were acknowledged by the Snøhvit Sponsors, far less implemented) were to extricate K-Euro in the extreme circumstances of insolvency of one of the Snøhvit Sellers or a Vessel being off hire for the long term (a remote possibility in view of the nature and purpose of the time charter). We cannot see that

this is a basis for a case that K-Euro was not commercially engaged as operator of the Vessels, or that it was in some way simply a representative for the Snøhvit Sponsors. Even if one were to accept that it was always the intention that they should be proportionate shareholders in K-Euro (and there is no clear evidence that that was the intention in September 2002 – there was the obvious objection to that from K-Line's viewpoint, namely that they would thereby participate as such shareholders in all the other business which K-Line intended that K-Euro should undertake), that does not of itself mean that K-Euro did not charter the Vessels for its own commercial objectives and as a matter of commercial substance. This course of events in itself demonstrates the commercial nature of the arrangements, which had to be re-negotiated to deal with changing circumstances: K-Euro was seeking to make a commercial profit (and not one which was in any way guaranteed or at a fixed margin), and when that profit proved to be illusory, and losses threatened K-Euro's activities, the relevant parties eventually agreed upon alternative arrangements.

420.We conclude therefore that a main object of the letting of the Vessels on charter, and of the grant of the bareboat charter to K-Euro and the novation of the timecharter to K-Euro, was to secure for K-Euro a commercial benefit, that commercial benefit accruing from operating the Vessels on charter with the intention of realising a profit for K-Euro. We also conclude that K-Euro entered into those transactions as part of, and in order to achieve, a wider commercial objective, namely the development of its business, in pursuance of the business strategy of the K-Line group, of operating and managing ships transporting bulk and gas products within, or to and from, the Atlantic Basin.

421.The question then is whether it was also a main object of the transactions to obtain the writing-down allowances. In arguing that this was so, the Commissioners pointed to the extensive and detailed advice as to UK tax and capital allowances which K-Line obtained during the period in which it was planning the arrangements for the financing of the Vessels.

422.The nature, extent and timing of that advice is set out in paragraphs 218 to 227 above. K-Line had no prior knowledge of the UK tax regime as it related to capital allowances, and relied on expert advice to assist it in its consideration of the funding possibilities available to it for the purchase of the Vessels. By the time K-Line entered into the Preliminary Stage in December 2001 it had concluded that a UK tax lease offered the most favourable funding option, and from January 2002 its advisers began the process of seeking possible finance lessors on the expressed basis that capital allowances would be available for their expenditure on the Vessels by reason of section 123 CAA 2001.

423.What is clear from the extensive and detailed emails between K-Line (its finance department in particular) and its advisers is that K-Line required the most precise and thorough advice as to the conditions which had to be met in relation to the chartering of the Vessels if the capital allowances were to be available. Much of that advice related to what was required in order that a company should be "a bona fide commercial UK shipping company" (shorthand for a person who lets a ship on charter in the course of a trade within the scope of section 123(1) CAA 2001). K-Line even

sought advice as to the profit margin which such a company would be expected to earn.

424.The Appellant says that once K-Line was aware that in principle capital allowances were available for the financing of the Vessels within the context of arrangements which accorded with the K-Line group's commercial intentions, it was merely prudent for K-Line to satisfy itself that it could and would meet the complex "qualifying purpose" conditions.

425.The Commissioners say that the purpose of seeking such detailed advice, which spilled over into matters such as the profitability of K-Euro which were commercial matters entirely within the competence and experience of K-Line, was to tailor the structure of the leasing of the Vessels so as to give the basis for a claim for the capital allowances.

426.It is clear that K-Line was intent on securing finance lease funding of the Vessels. Such funding offered certain non-tax commercial benefits (such as full funding without any initial deposit) and a UK finance lease prospectively offered the further commercial benefit of reduced cost of funding by reason of the capital allowances available to the finance lessor and shared by means of reduced rentals. The parties, in entering into the transactions for the letting of the Vessels on charter, had as an objective that the capital allowances should be obtained. K-Line sought advice so that it knew what the circumstances and conditions were that must obtain or be met in order that that objective could be achieved. We would characterise K-Line's attitude in seeking advice as being one of due diligence – the course of action was decided upon, but it needed to be as certain as it could before approaching prospective lessors that the arrangements it intended should be implemented would indeed secure the benefits to be derived from the capital allowances.

427.The objective of obtaining capital allowances was not a main objective of the transactions for the letting of the Vessels on charter. In our judgment the commercial objective we have identified above was paramount. Each transaction in the series of transactions relating to the letting of the Vessels on charter had a commercial purpose: it created an economic interest, transferred or shared a commercial risk, or was in pursuance of a genuine business endeavour. Overall, it is the case that the main objective of the transactions whereby, in September 2002, K-Euro took on the rights and obligations which would, on delivery of the Vessels, make it the disponent owner of the Vessels, was to achieve a commercial benefit distinct from, and not dependent upon, obtaining capital allowances. The capital allowances were a route to reduced cost of funds for the financing of transactions already decided upon. The parties knew this to be the case if the capital allowances proved to be available, and they wanted to obtain the benefit of such allowances, by ensuring that, in carrying out their commercial objectives, they would comply with the necessary conditions upon which the capital allowances were dependant. In terms of priority or hierarchy, that was subservient to, or of lesser importance than, achieving the commercial purposes of the relevant transactions.

428.We therefore conclude that the obtaining of writing-down allowances was not the main object, or one of the main objects, of the letting of the Vessels on charter or of any of the transactions in a series of transactions of which the letting of the Vessels on charter was one.

429.Accordingly we decide Issue 4 in the Appellant's favour.

Conclusion

430.Having decided each of the Issues as we have, we allow the Appellant's appeal in this case.

Costs

431.At the hearing the parties made no submissions as to costs. If this case has not been excluded from the costs regime which may apply to cases allocated as a Complex case under the provisions of Rule 10 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009, the Appellant may apply to us for an order for its costs and expenses.

Right to appeal

432.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.

EDWARD SADLER

TRIBUNAL JUDGE

ADRIAN SHIPWRIGHT

TRIBUNAL JUDGE

RELEASE DATE:12 January 2012

Authorities referred to in skeletons or included in authorities bundle and not referred to in the decision:

Inland Revenue Commissioners v Willoughby [1997] 1 WLR 1071
Wilson v First Country Trust Ltd (No. 2) [2004] 1AC 816
Peterson v Commissioners of Inland Revenue [2005] STC 448

APPENDIX
Short description of the transaction documents as appearing in the unchallenged witness statement of Mr Richard Owen Williams of Lloyds Banking Group

The transaction was signed on 19 September 2002. The structure of the documentation was as follows:

(a) A Novation Agreement in respect of two Shipbuilding Contracts each dated 19 December 2001 (as amended and supplemented from time to time) (the "**Shipbuilding Contracts**" made (1) between Mitsui Engineering & Shipbuilding Co. Ltd and Kawasaki Kisen Kaisha, Ltd ("K-Line") in respect of the Vessel with Hull Number 1564 and (2) Kawasaki Heavy Industries Ltd and K-Line in respect of the Vessel with Hull Number 1532 (the "**Shipbuilding Contract Novation Agreements**") pursuant to which the Appellant agreed to assume certain of the rights and obligations of K-Line to purchase, take delivery of and pay for each Vessel (the Shipbuilding Contracts as amended and novated by the Shipbuilding Contract Notation Agreements being the **"Novated Shipbuilding Contracts")**. The Novated Shipbuilding Contracts also made provision for a possible further novation to a replacement buyer.

(b) A Lease Agreement in respect of each Vessel pursuant to which the Appellant agreed to lease the Vessels to Northern LNG Transport Co I Limited and Northern LNG Transport Co II Limited (each a "Lessee" and together the "**Lessees**") and the Lessees agreed to lease the Vessels from the Appellant (the "**Leases**"). This contains the rental obligations

and the obligations of the Lessees to provide or procure the provision of security to the Appellant for the amounts due under the Lease.

(c) A Bareboat Charter Agreement of each Vessel (the "**Bareboat Charters**") pursuant to which the Lessees agreed to charter each Vessel to K Euro as the Bareboat Charterer.

(d) A Novation Agreement in respect of each Vessel pursuant to which K-Line novated its rights and obligations under two Time Charterparty Agreements to K Euro (each charterparty dated 19 December 2001 (as amended and supplemented from time to time) with Statoil ASA as operator (on behalf of the Snøhvit Sellers) pursuant to which Statoil agreed, following delivery, to take each Vessel on charter for an initial period of twenty years with two optional five year extensions (the "**Original Time Charters**")) (the "**Time Charter Novations**").

(e) A Quiet Enjoyment Letter for each Vessel addressed to Statoil and signed by, inter alia, the Appellant. The Bank of Tokyo-Mitsubishi, Ltd, as agent under the debt financing arrangements (the "**Agent**"), K Euro and each Lessee, pursuant to which, among other things, the signatories acknowledged they would not interfere with Statoil's full use and enjoyment of each Vessel provided Statoil performs its obligations under the Time Charter Novations (the "**Quiet Enjoyment Letters**").

(f) A Supervision Agreement in respect of each Vessel pursuant to which the Appellant appointed K-Line and K-Line accepted appointment as supervisor to supervise the construction of the Vessels on behalf of the Appellant (the "**Supervision Agreements**").

(g) A standby Put Option Deed in respect of each Vessel between the Appellant and Northern LNG Leasing Co Limited (the "**Standby Purchaser**") pursuant to which the Standby Purchaser granted the Appellant an option to sell, as the case may be, each Vessel to the Standby Purchaser (the "**Standby Put Option Deeds").** The obligation of the Standby Purchaser to pay the required purchase price under each Standby Put Option Deed would be funded by a bank or financial institution acceptable to the Appellant (the "**Standby Lender**").

(h) A Lease Agreement entered into between (i) the Standby Purchaser and (ii) each Lessee in relation to each Vessel and in respect of the leasing of each Vessel by the Standby Purchaser to the Lessee following delivery of each Vessel to the Standby Purchaser in accordance with the Standby Put Option Deeds (the "**Standby Leases**").

(i) A Deed of Application and Proceeds in respect of each Vessel entered into between (1) the Appellant, (2) each Lessee, (3) Statoil, K-Line, Mitsui & Co, Ltd and lino Kaiun Kaisha, Ltd (the "**Project Partners**"), (4) the Agent, (5) K Euro, (6) Lloyds TSB Bank plc (City Office) as Proceeds Account Bank, (7) the Hedging Bank, (8) the Standby Purchaser and (9) each other Lessee, dealing with the application of all proceeds under the Transaction Documents (as defined in the Leases) (the "**Deeds of Application and Proceeds**").

(j) A Guarantee in respect of each Vessel granted to the Appellant by the Project Partners guaranteeing of each the obligations of each Lessee and any Replacement Buyer (as defined in the Leases) under the Lease Documents (as defined in the Leases) (the "**Guarantees**").

(k) A Letter of Guarantee in respect of each Vessel issued by Lloyds TSB Bank plc in favour of each Lessee and the Agent guaranteeing the obligations of the Appellant under the Leases and the Deeds of Application and Proceeds (the "**Lessor Parent Guarantees**").

(l) A Letter of Guarantee in respect of each Vessel issued by Lloyds TSB Bank plc in favour of each of Mitsui Engineering & Shipbuilding Co, Ltd and Kawasaki Heavy Industries Ltd, guaranteeing the obligations of the Appellant under the Shipbuilding Contract Novation Agreements and the Novated Shipbuilding Contracts (the "**Lessor Parent Builders Guarantees**").

(m) A Deposit Deed and Deed of Assignment and charge entered into between (1) each Lessee, (2) Lloyds TSB Bank plc and (3) the Appellant pursuant to which Lloyds TSB Bank plc agreed to accept payments made into a cash collateral account opened by each Lessee and each Lessee charged all amounts standing to the credit of the cash collateral accounts to the Appellant as security for the obligations of each Lessee under the Lease Documents (as defined in each Lease) (the "**Deposit Deeds and Deeds of Assignment and Charge**"). This was to ensure that if problems occurred with the LC bank, that arrangements were in place under which the Appellant could obtain immediate alternative security from the Lessee; it was not expected that any amounts would even be paid into the cash collateral account, it was just there as a back up security.

(n) A Contribution Deed in respect of each Vessel entered into between the Appellant and each Lessee (the "**Contribution Deeds**") pursuant to which each Lessee agreed to make certain capital contributions to the Appellant in respect of amounts payable by the Appellant under the Shipbuilding Contracts and the Shipbuilding Contract Novation Agreements.

(o) A Letter of Credit in respect of each Vessel given in favour of the Appellant by HBOS Treasury Services plc (the "**LC Bank**") (the "**Letters of Credit**"). It should be noted at the time this transaction was completed HBOS was not part of the Lloyds Banking Group.

(p) A Panamanian Vessel Mortgage granted by the Appellant to each Lessee as security, inter alia, for the payment of all sums payable by the Lessor to each Lessee as rebate of rental on sale of the Vessel (the "**First Preferred Panamanian Vessel Mortgages**").

(q) The following security was granted to the Appellant:

(i) a Second Priority Security Assignment in respect of each Vessel granted to the Appellant by each Lessee as security for the obligations of each Lessee under each Lease (the "**Second Security Assignments**").

(ii) a Second Priority Floating Charge in respect of each Vessel granted to the Appellant by K Euro over all of K Euro's assets (the "**Second Floating Charges**");

(iii) a Second Priority Deposit Accounts Control Agreement in respect of each Vessel entered into by each Lessee and the Appellant as security, inter alia, for the obligations of each Lessee under each Lease (the "**Second Deposit Accounts Control Agreements**").

(iv) a Second Priority Shares Mortgage in respect of each Vessel granted to the Appellant by the Project Partners over each of their respective shares, stocks or other securities and investments in each Lessee (the "**Second Shares Mortgages**");

(v) a Deed of Covenants in respect of each Vessel entered into between (1) K Euro (2) each Lessee, (3) the Appellant and (4) The Bank of Tokyo-Mitsubishi Ltd as the Bareboat Charterer Account Bank (the "**K-Euro Deeds of Covenants**") pursuant to which K Euro provided certain covenants and assumed certain obligations in favour of the Appellant and the Lessee.

(vi) a package of security documents to be entered into giving the Appellant second priority security interests following the exercise of the standby arrangements.

(r) A Lessor Proceeds Account Charge in respect of each Vessel granted by the Appellant to the Agent to secure the obligations of the Appellant to pay all

amounts payable to each Lessee by way of rebate of Rental (as defined in the Leases) under each Lease and to discharge the Lessor Proceeds Obligations (as defined therein) (the "**Lessor Proceeds Account Charges**").

(s) A Letter of Undertaking given by each of Mitsui Engineering & Shipbuilding Co. Ltd and Kawasaki Heavy Industries Ltd to the Appellant in respect of each Vessel (the "**Builders' Undertakings**").

(t) A Letter of Undertaking given by each of Mitsui Engineering & Shipbuilding Co. Ltd and Kawasaki Heavy Industries Ltd to the Agent in respect of each Vessel signed by the Appellant (the "**Builders' Undertakings to the Agent**").

(u) The following side letters were also issued (the "**Side Letters**"):

(i) Tax Disputes Letter pursuant to which each Lessee and the Appellant agreed, inter alia, to inform and consult with each other and assume certain obligations towards each other on certain tax matters.

(ii) Indexation letter.

(iii) Pooling letter.

(iv) Negotiation Fee Letter.

(v) Swap Letter.

(vi) Change of Law Letter.

(vii) Standby Purchaser Administration Instruction Letter between, inter alias, the Company, the Agent and QSPV Limited.