Neutral Citation: [2026] UKUT 00305 (TCC)

Case Number: UT/2025/000038

UPPER TRIBUNAL
(Tax and Chancery Chamber)

The Royal Courts of Justice,
Rolls Building, London

CAPITAL ALLOWANCES – Tonnage tax – financing structure for the purchase and lease of ships to companies within the tonnage tax regime – whether lessors failed to qualify for capital allowances as a result of statutory provisions relating to the de-risking of ship leases – yes – appeal dismissed

Heard on: 18 and 19 May 2026
Judgment date: 7 August 2026

Before

JUDGE THOMAS SCOTT
JUDGE AMANDA BROWN KC

Between

FC SHIPPING LIMITED (1)
FB SHIPPING LIMITED (2)

Appellants

and

THE COMMISSIONERS FOR HIS MAJESTY'S REVENUE AND CUSTOMS

Respondents

Representation:

For the Appellants: Julian Ghosh KC and Harry Stratton, Counsel, instructed by Stephenson Harwood LLP

For the Respondents: Ben Elliott and Edward Hellier, Counsel, instructed by the General Counsel and Solicitor to His Majesty's Revenue and Customs

DECISION

INTRODUCTION

1. This is an appeal brought by FB Shipping Ltd (**FB**) and FC Shipping Ltd (**FC**) (together the **Appellants**) against the decision of the First-tier Tribunal (Tax Chamber) (the **FTT**) in *FC Shipping Ltd and FB Shipping Ltd v HMRC* [2024] UKFTT 1013 (TC) released on 6 November 2024 (the **Decision**).

2. The Appellants are companies which incurred capital expenditure on the acquisition of five ships, leased those ships and claimed capital allowances in respect of that expenditure. The Respondents (**HMRC**) disallowed the claims for capital allowances. The Appellants appealed against that decision to the FTT and the FTT dismissed their appeal. The Appellants now appeal to this Tribunal.

3. For the reasons set out below we have concluded that the FTT made no error of law and the appeal is dismissed.

4. We were greatly assisted in reaching our decision by the written and oral submissions of both counsel teams.

5. References below to paragraphs in the form [ ] are, unless stated otherwise or the context requires otherwise, to paragraphs of the Decision.

THE TONNAGE TAX REGIME AND THE ARRANGEMENTS IN OUTLINE

6. The tonnage tax regime (**TTR**) was introduced as a form of state aid and provides an alternative (and favourable) basis for taxing shipping companies who fall within the regime. Broadly, it calculates taxable profits for corporation tax purposes by reference to the ship tonnage rather than actual earnings. TTR specifically excludes the availability of capital allowances for the shipping companies within it. While lessors of ships to shipping companies within the TTR can, in principle, claim capital allowances, the availability of allowances is restricted for such lessors in the circumstances discussed below.

7. Five ships (the **Ships**) were acquired and leased under a structured financing arrangement. Each Appellant entered into a head lease (**Head Lease**) of a Ship to Fortis Finance (UK) Limited (**FF**), whose obligations were guaranteed pursuant to a guarantee **(FBSav Guarantee**) by Fortis Bank S.A./N.V. (**FBSav**). FF, in turn, sub-leased (**Sub-Lease)** each ship to various operating companies within the Vroon group of companies (**OpCos**). The OpCos paid tax pursuant to the TTR, and the intention of the parties was that the Appellants would be entitled to capital allowances on the purchase of each Ship.

THE LEGISLATION

8. A person may generally claim capital allowances for capital expenditure where that person carries on a "qualifying activity" and incurs qualifying expenditure: Capital Allowances Act 2001 section 11. However, Schedule 22 Finance Act 2000 (**Schedule 22**), which sets out the special rules for the TTR, removes the usual entitlement to capital allowances, by providing that a tonnage tax trade is not a qualifying activity: paragraph 68 of Schedule 22.

9. The provisions which are central to this appeal are contained in Part X of Schedule 22, in paragraphs 89 to 91. They provide as follows (so far as relevant and as in force during the periods relevant in this appeal):

> THE RING FENCE: CAPITAL ALLOWANCES: SHIP LEASING
>
> 89 (1) In the case of a lease of a qualifying ship provided, directly or indirectly, to a company within tonnage tax, the provisions of Part 2 of the Capital Allowances Act 2001 have effect subject to and in accordance with the provisions of—

paragraphs 90 and 91 (defeased leasing),

…

(2) In this Part of this Schedule "lease" means any arrangements that provide for a ship to be leased or otherwise made available by a person ("the lessor") to another person ("the lessee").

Defeased leasing

90 (1) The lessor under the lease is not entitled to capital allowances in respect of expenditure on the provision of the ship if—

(a) the lease, or

(b) any transaction or series of transaction of which the lease forms a part,

makes provision the effect of which is to remove the whole, or the greater part of, any non-compliance risk which, apart from that provision, would fall directly or indirectly on the lessor.

(2) For this purpose a "non-compliance risk" means a risk that a loss will be sustained by any person if payments under the lease are not made in accordance with its terms.

…

Defeased leasing: excepted forms of security

91(1) Paragraph 90 (defeased leasing) is subject to the following exceptions.

…

(5) It does not apply to the provision of security by a third party if the following conditions are met—

(a) no deposit of money or other property by way of security is obtained by the lessor or any third party;

(b) the security does not involve the assumption of any obligations of the lessee under the lease in return for a payment made (directly or indirectly) by the lessee or a person connected with him;

(c) the security does not give rise to any payments to the lessor unless the lessee defaults on the rental payments under the lease;

(d) any payments under the security are limited to the amount of the rental payments in default.

10. Part V of Schedule 22 contains a general anti-avoidance provision, with limitations in relation to leasing. The potential sanction for breach applies not to the lessor company, but instead excludes the shipping company from the TTR:

The requirement not to enter into tax avoidance arrangements

41 (1) It is a condition of remaining within tonnage tax that a company is not a party to any transaction or arrangement that is an abuse of the tonnage tax regime.

(2) A transaction or arrangement is such an abuse if in consequence of its being, or having been, entered into the provisions of this Schedule fall to be applied in a way that results (or would but for this paragraph result) in—

(a) a tax advantage being obtained for—

(i) a company other than a tonnage tax company, or

(ii) a tonnage tax company in respect of its non-tonnage tax activities, or

(b) the amount of the tonnage tax profits of a tonnage tax company being artificially reduced.

(3) In this paragraph "tax advantage" has the same meaning as in Chapter I of Part XVII of the Taxes Act 1988 (tax avoidance) (see section 709 of that Act).

(4) A lease is not to be taken as being an abuse of the tonnage tax regime by reason of the lessor obtaining capital allowances as a result of the lease being, or having been, entered into.

In this sub-paragraph "lease", and "lessor" in relation to a lease, have the meaning given by paragraph 89(2).

Tax avoidance: exclusion from tonnage tax

42 (1) If a tonnage tax company is a party to any such transaction or arrangement as is mentioned in paragraph 41(1), the Inland Revenue may—

(a) if it is a single company, give notice excluding it from tonnage tax;

(b) if it is a member of a group, give notice excluding the group from tonnage tax.

(2) The effect of the notice in the case of a single company is that the company's tonnage tax election ceases to be in force from the beginning of the accounting period in which the transaction or arrangement was entered into.

(3) The effect of such a notice in the case of a group is that the group's tonnage tax election ceases to be in force from such date as may be specified in the notice.

…

RELEVANT FACTS

Agreed facts

11. Before the FTT there was agreement as to the following facts:

(1) The Appellants were UK-resident companies, subsidiaries of Alliance & Leicester Commercial Finance plc (later Santander Asset Finance plc), carrying on a business of leasing and financing assets: [1], [9] – [11].

(2) The Appellants acquired the Ships through novation of shipbuilding contracts originally entered into by Vroon group companies: [16] – [19].

(3) The total capital expenditure incurred on acquisition was approximately US$84m for the ships acquired by FB (the **FB Ships**) and US$79.7m for the ships acquired by FC (the **FC Ships**): [21] – [22].

(4) The ships were "qualifying ships" within Schedule 22: [18].

(5) Each Appellant entered into a 25-year Head Lease with FF as lessee: [23].

(6) Simultaneously, FF entered into the Sub-Lease for each Ship with the OpCos, also for 25 years: [28].

(7) The OpCos operated the Ships and entered into time charters with third parties: [31].

(8) FBSav, the parent of FF, guaranteed FF's obligations under the Head Leases: [27].

(9) Rental cashflows under both Head Leases and Sub-Leases were agreed: [25] – [26].

(10) Under the Sub-Leases, the OpCos prepaid substantial portions of rent exceeding 50% of total rental obligations (the **Prepayments**). For the FC Ships the Prepayment was 79.85%: [30].

(11) FF assigned rights to Sub-Lease earnings to the Appellants by way of security under lessee/lessor assignments: [32].

(12) The Appellants incurred capital expenditure on the Ships for the purposes of ship leasing and claimed capital allowances in the accounting periods ended 30 June 2005, 30 June 2006, 30 June 2007 and 16 November 2011, generating losses surrendered by way of group relief: [33] – [35].

Findings of fact

12. The FTT considered the evidence given to it and made the following findings of fact relevant to our decision.

Core Structure and Transactions

13. The transactions formed a structured financing arrangement comprising novation of ship purchase contracts to the Appellants; Head Leases; Sub-Leases to OpCos; guarantees by FBSav and prepayment-funded financing arrangements: [46].

14. The Sub-Leases provided for multiple categories of rent (A, B and C rentals) and included options for the substantial Prepayments, which were exercised. The Prepayments were funded by external loans under what were described as "Parallel Debt" arrangements and secured by extensive collateral including mortgages and assignments: [46].

15. Numerous additional security arrangements were in place, including assignments of lease income, account pledges and cross-default provisions, forming layered security protections across the structure: [47].

16. Under the Head Leases, no advance payments were permitted; rentals were payable annually in sterling; and termination payments included both a "Basic Termination Sum" (which was full recourse) and a "Special Termination Sum" (which was limited recourse): [48] – [49].

17. The Basic Termination Sum represented approximately 88% of the termination liability and was payable regardless of sub-lessee performance, whereas the Special Termination Sum (approximately 12%) depended on sub-lease performance: [49].

Commercial Context and Purpose

18. Internal documents demonstrated that the transaction was structured to provide the Appellants with exposure to a bank counterparty rather than the shipping group, with layered security protecting both rental and "strip" risks[1]: [53] – [54].

19. The credit ratings of FF (at AA) and Vroon (at BB) were material to structuring decisions: [57].

20. The identity of the head lessee was a significant feature, regarded as providing a better credit risk and more favourable security position than the OpCos: [58].

21. At least one purpose of the structure was to convert exposure from shipping risk to bank risk and to provide multiple layers of security: [59].

[1] The "strip risk" refers to the risk that tax would be accelerated (as compared to the taxation of normal rental payments over time) on payments received on a default under the Head Lease.

22. There was insufficient evidence of any alternative purpose for the guarantee arrangements and financing mechanisms beyond providing security: [60].

Composite Nature of the Transactions

23. The Head Leases and Sub-Leases were entered into contemporaneously and were interdependent in their terms and operation: [61].

24. Prepayments were pre-planned and integral to the overall structure: [62].

25. The arrangements constituted a single composite transaction: [63].

Role of FF

26. FF was a special purpose vehicle whose sole activity was acting as intermediate lessor, and which had no independent income streams: [64].

27. Prepaid rental funds were deposited with FF's parent, FBSav: [65].

Capital Allowances Context

28. Transaction documents included provisions designed to preserve eligibility for capital allowances and ensure TTR qualification: [66] – [67].

29. The financing was priced on the basis that the OpCos would be within the TTR: [68].

Scope of the Guarantee

30. The FBSav guarantee extended beyond rental obligations to include additional liabilities such as funding costs, warranty breaches and misconduct-related liabilities, and therefore to payments not properly characterised as rent: [69] – [70].

FTT DECISION

31. What follows is a summary of the Decision, and we provide further detail of the FTT's analysis in our discussion of the Appellants' grounds of appeal.

32. The substantive issue before the FTT was whether paragraph 90 applied, with the result that capital allowances were denied because the leases and/or associated transactions "de-risked" the arrangements by removing the greater part of the loss arising from non-payment under the lease (defined as "non-compliance risk").

33. The determination of that issue raised three subsidiary questions:

(1) the scope of the "lease" for the purposes of the statutory test, and whether the Head Lease and Sub-Lease must be considered together;

(2) whether various elements of the structure, specifically the interposition of FF, the FBSav Guarantee and the Prepayment arrangements, constituted "provisions" relevant to paragraph 90; and

(3) whether any of those elements constituted "excepted forms of security" under paragraph 91, such that they fell to be disregarded in the measurement of risk reduction.

34. The FTT approached the interpretation of the statutory provisions purposively, having regard to the structure and history of Schedule 22. It emphasised that paragraphs 89–91 of Schedule 22 were designed to strike a balance: permitting some finance leasing to companies taxed under the TTR but denying capital allowances where the lessor's exposure to non-payment risk had been substantially removed.

35. As to the definition of "lease" in paragraph 89 (the **Paragraph 89 Lease**), the FTT rejected the Appellants' contention that the relevant lease was confined to the Head Lease. It held that the statutory definition, which includes "any arrangements" by which a ship is made available directly or indirectly to a tonnage tax company, required a broader analysis. On that

basis, the Head Lease and Sub-Lease together constituted the relevant Paragraph 89 Lease, with the Appellants as lessors and the OpCos as lessees.

36. The FTT further held that, in assessing whether paragraph 90 applied, it was necessary to consider not only the Paragraph 89 Lease but also any transactions of which it formed part. Given the contemporaneous and interdependent nature of the arrangements, the entire financing structure fell to be considered, subject only to the exclusion of any "excepted security" under paragraph 91.

37. The Appellants' contention that the FBSav Guarantee was an "excepted security" was rejected by the FTT. It concluded that:

(1) the guarantee did not satisfy the requirement in paragraph 91(5)(a) that no deposit be obtained "by way of security", because the substantial Prepayments under the Sub-Leases functioned as deposits providing security within the overall structure, and

(2) the guarantee failed the condition in paragraph 91(5)(d), because it extended to liabilities beyond unpaid rental and was therefore not limited to rental payments in default. Accordingly, the guarantee was not excluded from consideration in the de-risking evaluation.

38. When identifying the "provisions" relevant to paragraph 90, the FTT rejected the Appellants' argument that the identity of the Head Lessee could not constitute a "provision". Construing the term broadly, it held that the arrangements "made provision" for an intermediate leasing structure in which the Appellants' immediate counterparty was a financial institution rather than the OpCos. That structural feature was capable of being a relevant provision.

39. The FTT identified three "provisions" which fell to be analysed in terms of their effect on non-compliance risk:

(1) the Head Lease with a banking counterparty;

(2) the FBSav Guarantee; and

(3) the rental Prepayments made by the OpCos.

40. In considering the concept of non-compliance risk, the FTT held that it encompassed the risk of any loss arising from non-payment under the arrangements, not merely the risk of non-payment of rental. It rejected the approach advanced by the Appellants that the relevant assessment of risk (with and without the provisions) centred on exposure to loss rather than the probability of loss where default occurred.

41. The FTT accepted that the relevant risk for the Appellants lay in the risk that FF would fail to make the payments due under the Head Lease. However, in assessing the impact of the relevant provisions, it was necessary to consider the broader arrangements through which that risk was reduced.

42. On the evidence, including expert evidence, the FTT found that the combination of (i) implementing a Head Lease/Sub-Lease structure with FF and (ii) the FBSav Guarantee substantially reduced the likelihood of loss. In substance, those provisions replaced exposure to the credit risk of the shipping OpCos (with their BB credit rating) with exposure to a highly rated bank. That reduction in risk was central to the commercial rationale of the transactions.

43. The FTT concluded that those two provisions, taken together, removed the greater part of the non-compliance risk within the meaning of paragraph 90. That conclusion was supported both by expert analysis and by the FTT's own assessment of the commercial effect of the arrangements.

44. HMRC's submission that the Prepayment arrangements, viewed in isolation, independently removed the Appellants' risk was rejected. The FTT held that, because the Appellants had no security or proprietary interest in the prepaid sums held by FF, the Prepayments did not, of themselves, reduce the Appellants' exposure to non-payment under the Head Lease. However, that conclusion did not affect the overall result. Since the combination of the intermediate lessee structure and the FBSav Guarantee removed the greater part of the relevant risk, paragraph 90 was engaged and denied capital allowances.

45. Accordingly, the FTT held that the Appellants were not entitled to capital allowances in respect of the Ships. The appeals were therefore dismissed.

GROUNDS OF APPEAL

46. The Appellants now accept that the Paragraph 89 Lease comprises the Head Lease and Sub-Lease together, and no longer challenge that decision by the FTT. Therefore, the grounds of appeal below fall to be determined on that basis.

47. Permission to appeal was granted by the FTT in respect of the following grounds:

Ground 1 – Measuring the reduction of non-compliance risk

(1) The FTT erred in law in the construction and application of paragraph 90(1) when assessing whether the "greater part" of the non-compliance risk had been removed. In particular, the FTT wrongly determined the reduction in risk as a proportion of an already reduced level of risk (i.e. after taking account of other features of the arrangements) rather than determining the extent of any reduction in non-compliance risk as measured against the total risk (i.e. 100%).

Ground 2 –The Bank risk provision

(2) The FTT erred in law by comparing the Head Lease to a hypothetical lease (between the Appellants and the OpCos) and, as a result, treating the identity of the Head Lessee/Sub Lessor as a "provision" of the Paragraph 89 Lease.

Ground 3 – Non-compliance risk measures loss and not the risk of non-payment

(3) The FTT erred in rejecting the evidence of the Appellants' expert that as a result of the definition of "non-compliance risk" the correct assessment is of the loss arising if payments are not made in accordance with the terms of the relevant lease rather than an assessment of the probability of non-payment.

Ground 4 – FBSav Guarantee was an excepted security

(4) The FTT erred in concluding that the FBSav Guarantee was not an excepted security meeting the terms of paragraph 91(5). The Prepayments made by the OpCos to FF were not "by way of security" for the Appellants so as to engage paragraph 91(5)(a), and the FBSav Guarantee was limited to amounts referable to rental payments and therefore satisfied paragraph 91(5)(d).

48. In their response to the Appellants' grounds of appeal, HMRC challenged the FTT's Decision that the Prepayments were not "provisions" of the Paragraph 89 Lease which had the effect of reducing the non-compliance risk. Broadly, HMRC contended that the FTT erred in this respect by failing to consider the transactions as a composite arrangement which was intended to and did operate in a certain way. We refer to this as the HMRC Response Issue.

49. Neither party took the grounds of appeal sequentially. HMRC dealt with Grounds 2 and 4 first, followed by Grounds 3 and 1. This was on the basis that the logical first stage of the exercise was to identify the relevant "provisions" of the Paragraph 89 Lease (the subject of Grounds 2 and 4) and then to consider whether the FTT's methodology in calculating the

reduction in non-compliance risk was wrong (the subject of Grounds 3 and 1). We agree that approach is sensible, and consider the grounds in that order[2].

THE APPROACH TO LEASING IN SCHEDULE 22: PARAGRAPH 90 AND PARAGRAPH 41

50. The general anti-avoidance provision of paragraph 41 (**paragraph 41**) was not a focus of the appeal before the FTT. At first blush that might seem surprising, given the FTT's finding that the arrangements were a pre-ordained series of transactions. However, the FTT succinctly explained the position as follows, at [102] - [106]:

> **The preordained nature of the transactions**
>
> 102. Before we move onto the detailed application of the Schedule 22 rules we address one point which arose in submissions.
>
> 103. In this case there was a preordained series of transactions, but this is entirely consistent with this type of financing. A series of transactions was put in place as a package in order to finance the acquisition of the Ships.
>
> 104. As we have explained, the tax benefit of the Appellants buying the Ships used by companies within the tonnage tax regime, where the Appellants could claim capital allowances, is not by itself something which Parliament has sought to prevent.
>
> 105. Furthermore, this case is not one in which HMRC are seeking to invoke the anti-abuse provisions contained in paragraph 41-42. Those provisions enable HMRC to issue a notice excluding a company or group from the tonnage tax regime where a tonnage tax company has entered into an abuse of transaction or arrangement under paragraph 41 with the result that the companies or groups tonnage tax election ceases to be in force. Instead, HMRC are seeking to rely upon provisions contained in paragraphs 89 and 90 which provide that the lessor is not entitled to capital allowances.
>
> 106. We therefore agree with Mr Ghosh that the issue is not that a series of preordained transactions has been entered into for a lease financing – instead, the issue is whether the provisions of paragraph 90 are triggered to deny capital allowances in relation to the Ships to the Appellants.

51. So, before the FTT both parties accepted that the appropriate way to challenge and test the effectiveness of the arrangements was by reference to paragraph 90, and not paragraph 41. In this appeal, that continued to be the position until the hearing; neither party's skeleton argument discussed paragraph 41.

52. However, in oral submissions Mr Ghosh sought to rely on HMRC's ability to challenge leasing arrangements to TTR companies under paragraph 41 rather than paragraph 90. In general, an appropriate way to challenge defeased leasing arrangements which HMRC contend are abusive, said Mr Ghosh, was under paragraph 41. That position was presented as an answer to HMRC's objections that the practical effect of certain of the Appellants' grounds of appeal was to render paragraph 90 redundant or virtually redundant.

53. Mr Ghosh's argument seems to us to highlight an important issue which requires consideration in the exercise of purposive statutory construction we must undertake in considering the grounds of appeal, namely the approach taken by Parliament in Schedule 22 in relation to leasing to companies within the TTR.

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[2] The Appellants' skeleton argument recognised a further advantage of this approach, stating at paragraph 10 that "the FTT considered these two features [the identity of the Head Lessee and the FBSav Guarantee] together. That is not surprising, in circumstances where the expert evidence suggested their effect was best measured in combination".

54. Mr Ghosh argued that paragraphs 41 and 90 perform distinct and complementary functions within the statutory scheme in Schedule 22 and are not mutually exclusive. He submitted that paragraph 90 is a targeted anti-avoidance provision dealing specifically with defeased leasing, namely cases in which the lessor's non-compliance risk has, to the specified degree, been removed. Paragraph 90 is said to operate by way of a mechanical, threshold test, directed solely at the quantum of risk retained. By contrast, paragraph 41 is said to be a general anti-abuse provision. Its function is to address arrangements which are abusive in a broader sense, with consequences (expulsion from the TTR regime) that are qualitatively different from the denial of capital allowances under paragraph 90. Mr Ghosh contended that the two provisions therefore address different mischiefs: paragraph 90 addresses excessive risk defeasance in leasing structures and paragraph 41 addresses wider abusive arrangements (including leasing) which are not necessarily captured by the paragraph 90 threshold.

55. Mr Ghosh rejected the proposition that the existence of paragraph 90 renders paragraph 41 inapplicable to leasing arrangements, contending that such a proposition was legally erroneous and inconsistent with the statutory structure. He also rejected HMRC's contention that on the Appellants' case paragraph 90 had no practical application. In Mr Ghosh's submission, the relationship between paragraphs 90 and 41 reflects Parliament's deliberate design: paragraph 90 is confined to extreme cases, with paragraph 41 operating as a broad, residual safeguard against abuse not meeting the paragraph 90 threshold.

56. Mr Elliott and Mr Hellier submitted that, in the context of paragraph 89 leasing arrangements, paragraph 41 and paragraph 90 operate in a mutually exclusive manner, with paragraph 90 providing the applicable rule for defeased leases. Paragraph 90 is said to be the specific provision directed to the relevant mischief, namely the use of leasing structures within the TTR to secure capital allowances while eliminating meaningful risk. As such, it governs the availability of allowances where it applies. Paragraph 41, by contrast, is a general and more draconian provision with the significant consequence of removal from the regime. Paragraph 41 is not intended to overlap with the more calibrated response in paragraph 90. HMRC's position was that, where an arrangement potentially falls within the scope of paragraph 90, it is that provision which determines the outcome. This reflects a principle of specificity, with the targeted rule displacing the general one. HMRC further relied on the legislative scheme and Explanatory Notes to submit that Parliament addressed the perceived abuse of risk-defeased leasing specifically through paragraph 90 and did not intend paragraph 41 to be invoked in parallel for the same mischief.

57. On the face of the legislation, paragraph 41 is a general anti-avoidance provision addressing abuse of the TTR. Abuse carries a draconian sanction, being exclusion of the shipping company from the scheme altogether. An arrangement is abusive if it gives rise to a tax advantage for either a company within the TTR or another company. Companies within TTR are expressly excluded from being eligible to claim capital allowances. As such, and by reference to the terms of paragraph 41(1) and (2) alone, it might be thought that abusive arrangements by which capital allowances are claimed by a lessor of Ships used by a lessee within TTR and then effectively fed back down to the company in TTR would result in the TTR company being excluded from the TTR. However, and critically, paragraph 41(4) expressly provides that a lease is not to be taken as being an abuse of the TTR by reason of the lessor obtaining capital allowances as a result of a paragraph 89 lease being, or having been, entered into.

58. We do not accept Mr Ghosh's characterisation of the effect and purposes of paragraphs 90 and 41.

59. Paragraph 90 imposes a limited restriction on the ability to claim capital allowances for those outside the TTR when leasing ships to companies within the TTR. Provided that the leases meet the terms of paragraph 89, capital allowances can be claimed and there is no abuse. In other words, the tax advantage accruing to the lessor (a company outside the TTR) through a claim to capital allowances which could not have been claimed by the lessee within TTR is not an "abuse" which causes the TTR company to be precluded from accounting for tax from within TTR. That is the effect of paragraph 41(4). However, such claims to capital allowances are expressly limited by the terms of paragraph 90.

60. That linguistic interpretation is supported by the rationale for how and why capital allowances are permitted for lessors of ships under Schedule 22. This can be derived from the Independent Enquiry into a Tonnage Tax[3] (the **Alexander Report**) and the Explanatory Notes to the Finance Bill 2000 (**ENFB00**) and to the Finance Bill 2003 (**ENFB03**). These materials indicate as follows:

(1) It was intended that "unlimited 25% capital allowances would no longer be appropriate to a virtually tax-exempt regime and any capital allowance for ships leased to companies within the [TTR] should be significantly restricted": paragraph (xi) of the executive summary to the Alexander Report.

(2) Leasing represented the most difficult issue in the design of the TTR. The availability of capital allowances to lessors of finance leases for ships enabled companies within the TTR to indirectly obtain the benefit of capital allowances despite lacking taxable profits against which to set the allowances. However, it was important to maintain UK competitiveness as against the TTR regimes available in other jurisdictions (particularly Germany and the Netherlands). The legislative solution devised sought to balance simplicity, cost control and competitiveness whilst minimising avoidance risk (paragraphs 80 – 85 of the Alexander Report).

(3) The principal control mechanism was provided through Part X of Schedule 22 to deny capital allowances in respect of defeased or collateralised leasing (paragraph 92(j) of the Alexander Report).

(4) The objective of Part X Schedule 22 is set out in ENFB00. It explains that "if there were no special rules to prevent it, tonnage tax companies could still access the benefit of capital allowances through finance leasing. Where a ship is leased the capital allowances go to the lessor and the benefit of those allowances may be shared with the lessee …Without special rules it would be open to tonnage tax companies to route all their ship purchases through a bank, using it as a conduit to access tax reliefs otherwise unavailable to those tonnage tax companies. To prevent this, Part X places restrictions on the capital allowances available to finance lessors" (paragraphs 207 and 208 ENFB00).

(5) ENFB00 also explained that paragraph 41 of Schedule 22:

> 104. … provides that, in order to remain within the tonnage tax regime, a company must not enter into any transaction or arrangement that is an abuse of the tonnage tax regime (paragraph 41(1)).
>
> Such a transaction or arrangement is one which results in the tonnage tax regime being applied so that a tax advantage, or an artificial reduction in tonnage tax profits is obtained (paragraph 41(2)). The term "tax advantage" is

[3] Independent Enquiry into a Tonnage Tax, a report by Lord Alexander of Weedon QC, published 12 August 1999.

further described in paragraph 41(3) and, broadly, is the increase in any relief from, or repayment of, or avoidance of a charge to, tax.

105. Paragraph 41(4) provides specifically that entering into a finance lease is not to be regarded as an abuse of the tonnage tax regime simply because the lessor can obtain capital allowances…

(6) Operating leases were originally excluded from Part X because "the lessor is genuinely carrying a reasonable share of the risks and rewards of ownership of the leased asset" (paragraph 208 ENFB00).

(7) ENFB00 paragraph 212 explains:

Paragraph 90(1) means that where a qualifying ship is leased to a tonnage tax company under a finance lease where most of the risk has been defeased, no capital allowances will be available to the lessor in respect of any expenditure on that ship. A 'defeased' lease is explained in paragraph 90(1) and (2) as a lease where the lessor, or a person connected with him, who would otherwise carry most of the risk of payments not being made under the lease, arranges for that risk to fall elsewhere.

(8) Amendments were made to Part X by Finance Act 2003, in particular to extend the scope of the defeased leasing restriction on claiming capital allowances. The amendments replaced references to finance leases with reference to "leases" such that "all capital allowance claims on qualifying ships provided to a company within tonnage tax are potentially affected by the restrictions set out in Part X … subject to the exceptions set out for ordinary charters." This was explained at paragraph 16 ENFB03:

Some lessors, however, began offering long-term leases for ships that have many of the characteristics of finance leases without being finance leases in form. Such leases could be used to allow lessors to claim significantly more in capital allowances than had been intended when the tonnage tax was introduced. The new provision extends the types of leases to which the restrictions apply.

61. This analysis clearly supports HMRC's interpretation of the purposes and effects of paragraphs 90 and 41. We do not need to decide in this appeal whether paragraphs 90 and 41 are mutually exclusive in every conceivable situation, but it is clear that in relation to leasing arrangements such as those in this appeal the availability of a challenge under paragraph 41 to the ability of a shipping company to remain in the TTR does not and was not intended by Parliament to operate as an alternative (let alone the primary) mechanism to the denial to the lessor of capital allowances under paragraph 90.

GROUND 2: THE BANK RISK PROVISION AND THE APPROPRIATE COMPARATOR

62. Paragraph 90 requires a determination of whether the lease, or any transaction or series of transactions of which the lease forms a part, makes provision the effect of which is to remove the whole, or the greater part of, any non-compliance risk which, apart from that provision, would fall directly or indirectly on the lessor. The effect of paragraph 89(2) is that the "lease" is the Paragraph 89 Lease, and as the FTT held (and the Appellants now accept) that means the Head Lease and Sub-Lease in combination.

63. The FTT decided that in measuring the effect of the identity of the Lessee on the non-compliance risk, this required a comparison between the actual composite arrangements (the Paragraph 89 Lease) with the terms of the Head Lease alone. In doing so, the FTT decided that the identity of the Head Lessee was a "provision the effect of which" was to reduce the non-compliance risk which, "apart from that provision", would fall directly or indirectly on the lessor.

64. Ground 2 asserts that this was an error of law.

Appellants' submissions

65. The Appellants make the following submissions:

(1) The FTT's approach impermissibly rewrites the actual agreements between the parties so as to assume the existence of a direct lease between the Appellants and the OpCos. That is said to be contrary to the approach directed by the House of Lords in *Barclays Mercantile Business Finance Ltd v Mawson [2005]* 1 AC 684 (at [36]) and the Court of Appeal in *HMRC v BlueCrest Capital Management LP* [2023] EWCA Civ 1481 (at [74]). They contend that on the accepted evidence the Appellants would never have entered a direct lease with the OpCos, so it is impossible to measure a direct relationship realistically, by collapsing the Head Lease and Sub-Lease structure or otherwise. The provisions of the Head Lease and Sub-Lease are not identical, so which would prevail?

(2) As a matter of language, regarding the identity of a counterparty as a "provision" of a lease (even a Paragraph 89 Lease) is odd. The identity of the lessee is a characteristic of the lessee and intrinsic to it but it is not a provision of a lease.

(3) In the context of assessing whether non-compliance risk has been defeased the FTT accepted that it was the Appellants' risk under the Head Lease which was relevant.

(4) The proper exercise under paragraph 90 is to take the actual lease (which is accepted to be the Head Lease plus Sub-Lease), identify individual provisions within that structure, and assess their effect on the lessor's real risk, being its risk under the Head Lease. The use of any other counterfactual is inconsistent with the statutory scheme because paragraph 90 refers to "the lease, or … transactions of which the lease forms a part" and this requires consideration of the actual composite transaction.

(5) More generally, the FTT's approach collapses the statutory inquiry into a comparison between "bank risk" and "shipping company risk", which is not what paragraph 90 directs. The statute requires an examination of the effect of provisions within the actual transaction, not an abstract comparison between different hypothetical risk profiles. As such it leads to arbitrary results, effectively assuming a baseline of risk derived from a different (and potentially riskier) counterparty, rather than asking what risk the Appellants actually bore under the structure they entered into. A construction should not be adopted which produces arbitrary results: *R (on the application of Edison First Power Ltd) v Central Valuation Officer* [2003] UKHL 20 (at [139]).

(6) If HMRC considered that the arrangements were abusive because they replaced shipping company risk with bank risk, that was a matter appropriately dealt with under paragraph 41.

HMRC's submissions

66. HMRC said that the FTT got it right, for the following reasons:

(1) The FTT did not undertake any impermissible comparison with a hypothetical direct lease. Rather, it applied paragraph 90 by reference to the actual composite arrangements as required by paragraph 89, which included all of the arrangements by which the Ships were made available to the OpCos i.e. including the Head and Sub-Leases and the FBSav Guarantee. Paragraph 90 requires a consideration and comparison of the Paragraph 89 Lease with and without the provisions which reduce risk to the owner of the Ships, in order to determine if the greater part of the risk under the Paragraph 89 Lease without the provisions has been defeased. This is a comparison between two states of the same transaction, not between two different leases.

(2) The FTT examined the actual arrangements as a whole, including the Head Lease and the Sub-Lease through which FF was interposed precisely for the purpose of derisking the transaction and substituting banking risk for shipping risk. No question as to the "identity" of the lessee arises. The lessees of the Paragraph 89 Leases are the OpCos; the Head/Sub-Lease structure represents a provision of the arrangements and thereby the Paragraph 89 Lease by which the Ships are made available. The statutory question is whether the Paragraph 89 Lease or related transactions "make provision the effect of which is to remove" risk; that wording directs attention to the commercial substance and effect of the arrangements, not to formal distinctions between provisions and structural features.

(3) The Appellants' approach would undermine the effective operation of paragraph 90 because it would prevent the recognition of arrangements which achieve de-risking through structural features of the transaction. In particular, it would exclude from consideration precisely the type of arrangement which Parliament intended to target.

(4) The FTT's decision was entirely consistent with the purpose of the legislation. Paragraphs 89–91 were enacted to prevent TTR companies from accessing capital allowances via structures in which a bank is interposed as a conduit and assumes the substantial risk. The present structure was a prime example of such arrangements.

Discussion

67. There was no error of law in the FTT's reasoning or conclusion on this issue.

68. The FTT correctly directed itself as to the proper interpretation of the relevant statutory provisions at [84]. In short, that is to construe the statutory language, in context, purposively and apply it to the actual transactions undertaken viewed realistically and, in the round, taking proper account of the relevant statutory definitions.

69. The Appellants have not, rightly in our view, challenged the FTT's conclusions at [113] and [116] that the Paragraph 89 Lease comprised the entire package of arrangements by which the Ships were made available by the Appellants to the OpCos, including the Head Lease and Sub-Lease. Having first determined the scope of the Paragraph 89 Lease, the FTT then addressed the question of whether the interposition of FF was a provision at [157] – [163]. It set out the positions of the parties and concluded that the interposition of a bank between the Appellants and the OpCos was a provision of the Paragraph 89 Lease, the effect of which was to reduce the non-compliance risk.

70. We agree. The Paragraph 89 Lease was the means by which the Ships were made available by the Appellants (indirectly) to the OpCos. The "provisions" by which that statutory lease was affected includes every feature of the arrangements. The Head and Sub-Leases were an obvious and necessary feature of the arrangements. We agree with the FTT and HMRC that this approach does not entail challenging the identity of the lessee or rewriting the agreements or arrangements. The statutory test calls for a forensic examination of the actual arrangements in place. The arrangements implemented by the Appellants included the interposition of FF between the Appellants and the OpCos, and as such the effect of that interposition on the risk borne by the Appellants was properly to be assessed when considering whether that provision defeased the Paragraph 89 Lease.

71. We do not accept that the FTT's construction of the provisions would produce absurd results, as we discuss shortly in relation to the FTT's overall conclusion.

72. The appeal under Ground 2 is dismissed.

GROUND 4: THE FBSAV GUARANTEE WAS AN EXCEPTED SECURITY

73. In determining the extent to which the arrangements reduce non-compliance risk, paragraph 91 exempts certain forms of security from that determination. In this appeal, the issue was whether the FBSav Guarantee fell within the form of exempt security set out in paragraph 91(5). That exemption applies to the provision of security by a third party which meets four conditions. Two of those conditions were said by HMRC not to be satisfied. The first, in paragraph 91(5)(a), is that "no deposit of money or other property by way of security is obtained by the lessor or any third party" (the **Security Condition**). HMRC said that the Prepayments breached this condition. The second, in paragraph 91(5)(d), is that "any payments under the security are limited to the amount of the rental payments in default" (the **Rental Limitation Condition**). HMRC said that payments under the FBSav Guarantee were not so limited.

74. It was common ground before the FTT that the FBSav Guarantee amounted to "the provision of security" for the purposes of paragraph 91(5).

The FTT's decision on the issue

75. As regards the Security Condition, the FTT held that this was not satisfied. Although the Sub-Lease Prepayments were not subject to any charge and were not made under the terms of the FBSav Guarantee, the FTT considered that the statutory language required a functional, rather than narrow, legal analysis of whether sums were provided "by way of security": [131]. On the evidence, the Prepayments formed part of a "layered" security structure and served to make payment flows more certain. In particular, they operated as security for the Sub-Lease rentals in the hands of FF, a third party, and were accordingly deposits "by way of security" within paragraph 91(5)(a): [136]. In a broader commercial sense, the Appellants derived security from the fact that substantial funds were held within a special purpose vehicle backed by a highly rated bank: [139] – [140]. On this basis, the FTT concluded that the condition in paragraph 91(5)(a) was breached and that, as a result, the FBSav Guarantee could not qualify as an excepted security for that reason alone: [143].

76. As regards the Rental Limitation Condition, the FTT rejected the Appellants' submission that all amounts payable under the Head Lease (including termination sums and ancillary liabilities) should be treated as "rentals", emphasising that the statutory language refers to the actual nature of the payments, not their contractual characterisation: [147]. On the facts, the FBSav Guarantee extended to liabilities beyond unpaid rent, including warranty claims and other non-rental obligations: [149]. It further held that the security must be assessed in the round and could not be disaggregated into separate obligations so as to satisfy the statutory condition "to the extent" of rental payments: [151] – [152].

77. Accordingly, the FTT concluded that payments under the FBSav Guarantee were not limited to rental payments in default and so, for this additional reason, failed to satisfy paragraph 91(5)(d): [153].

Appellants' submissions

The Security Condition

78. As regards the Security Condition, Ground 4 asserts that the FTT erred because the Prepayments did not constitute "security" within the meaning of the legislation. The Appellants place reliance on the drafting of the transaction documents, emphasising that where the parties intended to create security, they did so expressly, and emphasise that that no proprietary or security interest was created in respect of the Prepayments.

79. The FTT erred in treating the Prepayments under the Sub Leases as a "deposit of money …by way of security" for the Appellants. Those Prepayments were, on their proper

characterisation, advance rental payable to FF under the Sub-Leases. FF was free to do what it wanted with the Prepayments. As acknowledged by the FTT, the Appellants had no proprietary interest in, or recourse to, those sums and there was no restriction on FF's use of them. The Prepayments were not referable to the FBSav Guarantee. They de-risked FF but not the Appellants. Accordingly, they could not constitute security "obtained by the lessor or any third party" for the purposes of paragraph 91(5)(a). The FTT impermissibly attributed a security function to what was, in substance and form, a commercial rental mechanism.

The Rental Limitation Condition

80. Ground 4 further asserts that the FBSav Guarantee also satisfied the separate condition in paragraph 91(5)(d) because it was limited to the obligations of the lessee. The Appellants relied in particular on the separability of obligations within the contractual terms of the FBSav Guarantee, including the provision which stated that each indemnity constituted a separate and independent obligation, and submitted that the liabilities were thereby confined in a manner consistent with paragraph 91(5).

81. The FTT erred in concluding that the guarantee extended beyond rental payments. On a proper construction of the Head Lease, all sums payable thereunder are to be treated as payments of rent, including the Basic Termination Sum, which represents the discounted value of future rentals. Accordingly, any payments falling due under the FBSav Guarantee are limited to amounts referable to rental obligations in default. To the extent that the guarantee also covers other obligations, those obligations are severable, and the guarantee should be analysed by reference to its rental component for the purposes of paragraph 91(5).[4]

82. More generally, the FTT's approach frustrates the purpose of paragraph 91, which is to permit commercial guarantees that support rental obligations without amounting to defeasance of risk. The specific concern identified in the Alexander Review was that lessors would de-risk finance leases by requiring a deposit of cash collateral with the lessor, but here the Prepayments were made to FF and not the Appellants. On the Appellants' case, the FBSav Guarantee is a paradigm example of an excepted security, and its effect should therefore be left out of account when applying paragraph 90.

HMRC's submissions

83. HMRC submitted that the FTT reached the correct conclusion, for the following reasons:

(1) The Security Condition is not satisfied because, by reason of the Prepayments, there was a "deposit of money…by way of security" obtained by the lessor or a third party. It is common ground that the Prepayments were a "deposit of money", and the statutory question is whether, as a matter of commercial reality, that deposit functioned as security. The FTT correctly held that it did so: the Prepayments were specifically contemplated as part of the composite transaction and constituted one of the "layers of security" within the overall financing structure. Paragraph 91(5)(a) is concerned with function rather than legal form. The term "provision of security" is not confined to proprietary rights, and a deposit may fall within the provision if it makes payment more assured or more readily recoverable. Further, the statutory language expressly extends to security "obtained by … any third party", so it is immaterial that the deposits were placed with FF or FBSav rather than by or for the direct benefit of the Appellants. Contrary to the Appellants' case, it is not necessary that the deposits be legally or mechanically referable to the guarantee itself.

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[4] The Appellants relied on clause 5 of the FBSav Guarantee, which provides that "each of the indemnities in this Guarantee and Indemnity constitutes a separate and independent obligation from the other obligations in this Guarantee and Indemnity [and] shall give rise to a separate and independent cause of action".

(2) In relation to the Rental Limitation Condition, the FBSav Guarantee is not limited to "the amount of the rental payments in default". On the findings of the FTT, the guarantee extends to a range of liabilities beyond rental payments, including broken funding costs, liabilities arising from misconduct, breaches of representations or warranties, and costs associated with maintaining the Ships following termination of the Sub-Lease. HMRC further submit that the Basic Termination Sum relied on by the Appellants does not, in any event, satisfy paragraph 91(5)(d). It is not a payment for the use of the Ships, but a payment arising on termination, which may include additional elements such as interest and is not confined to unpaid rentals. Nor is it permissible to isolate and treat as severable elements of the guarantee: the "provision of security" must be considered as a whole and cannot artificially separate rental and non-rental components.

Discussion

84. As regards the Security Condition, the relevant terms of paragraph 91(5) provide that the Paragraph 89 Lease will not be considered to be defeased by reference to the provision of a security (in this case the FBSav Guarantee) by a third party (FBSav) to the Paragraph 89 Lease lessor (the Appellants) provided that:

(a) there is no deposit of money, by way of security, obtained by the lessor or any third party; and

(d) any payments under the security are limited to the amount of the rental payment in default.

85. The FTT correctly construed this language and correctly applied it to the facts found. We agree with their analysis and reasoning as summarised above.

86. The terms of paragraph 91(5) will not be met where there is a deposit of money, the function of that deposit is to act as security and the money is received by either the Paragraph 89 Lease lessor or a third party. We agree with the FTT that the use of the words "by way of" signal a functional test. It was an agreed fact that the OpCos made substantial Prepayments to FF by way of a deposit of money paid into FBSav bank accounts. The Appellants accept that the money so deposited was "by way of security" provided by the OpCos to FF but contend that it is not "by way of security" to the Appellants.

87. There is no warrant for interpreting the clear wording to mean that the deposit must be by way of security to the Appellants. That is not changed because FF was free to deal with the Prepayments as it wished. Further, as correctly noted by the FTT at [135], the focus of attention of the drafter in paragraph 91(5)(a) is on whether there is any deposit (whose function is by way of security) and not to "the" security which may be excepted if all the conditions in paragraph 91(5) are met.

88. Since the FBSav Guarantee would only be an excepted security if it satisfied all four conditions in paragraph 91(5), this conclusion is sufficient to refuse the appeal on Ground 4.

89. However, since we heard argument on the Rental Limitation Condition, we will briefly set out our views on that issue. In questioning, Mr Ghosh accepted that the FBSav Guarantee included "all sorts of things which cannot be, commercially speaking, described as rentals" and that the parties "call them rentals, but they're not rentals". That appears to us to concede that the FBSav Guarantee was not limited to rental payments as required by paragraph 91(5)(d). However, and by reference to the analysis of the contractual documents presented by Mr Stratton, he sought to contend that the drafting construct providing for severability of the various obligations was sufficient to permit a conclusion that there were separate "securities" for the rental obligations. We cannot accept that argument. It appears to us that the FBSav

Guarantee provided maximum security to the Appellants to cover all obligations in respect of which there might be default, thereby de-risking even the use of a bank owned special purpose vehicle. Contractual provisions deeming all obligations to make payments to be rental and/or providing for severability cannot justify a conclusion that the "payments under the security are limited to the amount of rental payments in default" as required under paragraph 91(5)(d). As such we entirely agree with the FTT's analysis at [147].

90. The appeal under Ground 4 is dismissed.

91. Pausing there, the consequence of our dismissal of Grounds 2 and 4 is that the FTT was correct in taking into account the effect of both the intermediate lease and the FBSav Guarantee in assessing the extent to which the non-compliance risk had been reduced by the arrangements. We agree with the views which the FTT expressed when it stepped back and took stock of that conclusion, at [201]:

> Given the difficulties with the interpretation of this legislation we have considered this conclusion in the context of the purpose of the legislation identified by us earlier. We consider that, in effect, replacing the risk of a deal with a shipping company within the tonnage tax regime with the risk of a deal with a bank clearly reduces the non-compliance risk to which the Appellants were exposed. Indeed, that was the basis of entering into the transactions as shown by our findings earlier. Given the boundary drawn by Parliament in the legislation and the history of that legislation which we have addressed earlier, we are clear that this is a prime example of something which falls within the purpose of the rules in paragraphs 89-91. The Appellants entered into a transaction where the risk was less than that of leasing to the shipping companies. It has then been a matter of expert evidence to identify whether that reduction fell within the "greater part" test of paragraph 90.

GROUND 3: NON-COMPLIANCE RISK DOES NOT MEASURE THE RISK OF NON-PAYMENT

92. How does one calculate a reduction in non-compliance risk for the purpose of the provisions?

93. Before the FTT, each party produced an expert witness: Mr Bencard for the Appellants and Mr Sutton for HMRC. In terms of calculating a reduction in non-compliance risk, Mr Bencard put forward two methods of assessment (**Bencard 1** and **Bencard 2** respectively). The FTT described the two methods of assessment and their differences as follows, at [173] - [177]:

> 173. Mr Bencard has put forward two different assessments with very different conclusions. We therefore address the differences between them.
>
> *Mr Bencard's two assessments*
>
> 174. Mr Bencard describes the differences between his two assessments as follows:
>
>> "whereas the First Assessment involves assessing the risk of payments under the Head Lease not being made and expressing that risk is a probability weighted loss, both with and in the absence of the Provisions, the Second Assessment by contrast requires me to postulate that payments under the Head Lease are not made and then assess the risk of the relevant Appellant thereby sustaining a loss, both with and in the absence of the Provisions. The Second Assessment does not take into account the probability that a counterparty will default on payment under the Head Lease."
>
> …

> 176. In making his Second Assessment Mr Bencard says that he makes the following assumptions:
>
> (1) that there has been a failure to pay a Termination Sum by Fortis Finance; and
>
> (2) that there will be no payment from Fortis Finance because it is insolvent;
>
> (3) payment or part payment will not be made in the event of a distribution after administration or liquidation;
>
> (4) Fortis Bank is also insolvent and therefore cannot make any payments under the Fortis Bank Guarantee.
>
> 177. The differences between Mr Bencard's First and Second Assessments can be illustrated by his conclusion regarding the impact of Fortis Finance being lessee taken together with the Fortis Bank guarantee. He acknowledges that those provisions taken together do indeed reduce the likelihood of loss falling on the Appellants, but he maintains that they do not reduce the amount of loss which is the thing being measured under the Second Assessment because of the insolvency assumptions he has made.

94. The FTT rejected Bencard 2 as an incorrect approach. By Ground 3, the Appellants say that that was an error of law.

The FTT's decision on the issue

95. The FTT rejected the approach adopted in Bencard 2. Its reasoning can be briefly summarised as follows:

(1) The language of paragraph 90(2) does not identify a particular type of loss and is not limited to loss arising on an insolvency in particular circumstances: [178(1)].

(2) Bencard 2 does not address probability of non-payment despite the statutory reference to "risk" which implies a probability: [178(2)].

(3) Bencard 2 essentially assumes total loss and there is no assessment of partial loss howsoever arising, with no statutory basis for that assumption. This is to be contrasted with the use of default rates which are a recognised measure of expected risk including missed or delayed payments: [178(3) – (6)].

(4) By way of sense check, the Appellants' submissions would render the existence of parental guarantees an irrelevance and there would be no need to treat them as excluded under paragraph 91: [178(6)].

Appellants' submissions

96. The Appellants submitted that the FTT had adopted the wrong starting point in its analysis of non-compliance risk under paragraph 90(2). This is principally on the basis that, forensically analysed, the statutory language of paragraph 90(2) distinguishes between (i) non-payment, (ii) risk of loss, and (iii) the amount of loss. As non-payment under the terms of the Paragraph 89 Lease is assumed, the statutory test focuses on the risk that a loss will be sustained and does not require any assessment of the likelihood or risk of non-payment.

97. The definition of "non-compliance risk" in paragraph 90(2) requires the application of a two-stage approach. First, one assumes that payments under the lease are not made in accordance with the terms of that lease. Second, in that assumed state of affairs, an assessment must be made of the risk that a loss will thereby be sustained. On that footing, the statutory inquiry does not concern the probability of non-payment occurring, but the consequences of non-payment in the counterfactual world in which non-payment is postulated.

98. The structure of paragraph 91 supports this interpretation. The forms of "Excepted Securities" listed in paragraph 91 (such as guarantees) operate by reducing loss in the event of default, rather than by reducing the likelihood of default. That regime only makes sense if paragraph 90 is directed to the risk of loss following non-payment and not the risk of non-payment.

99. This interpretation is supported by the extra-statutory material considering the introduction of the TTR and the circumstances in which capital allowances needed to be restricted to avoid the benefit of capital allowances flowing through to companies within the TTR.

100. On that construction, both Mr Sutton's assessment and Bencard 1 were legally erroneous because they both measured the probability of non-payment (using default rates) rather than the consequences of non-payment.

101. By contrast, Bencard 2 gives effect to the conditional "if" in para 90(2). Bencard 2 focusses on the risk of loss which would accrue to the Appellants if FF failed to make payments in accordance with the terms of the Head Lease. Mr Bencard's opinion was that the only circumstance in which the Appellants would not receive payments under the terms of the Head Lease would be if FBSav (and thereby FF) were insolvent. This is on the basis, as accepted by Mr Sutton in cross-examination, that banks will universally stand by the commitments of their subsidiaries. As a result, failure by FF to meet the payment terms of the Head Lease would result in a 100% probability of total loss and there is no mitigation of this risk of total loss by any provision of the Paragraph 89 Lease.

HMRC's submissions

102. HMRC's submissions focussed on the concept of "risk". They contend that paragraph 90(2) requires an assessment of risk, which necessarily imports an assessment of probability of loss. The FTT is required to assess the probability that a loss will be suffered, rather than assess the amount of loss suffered on the assumption that non-payment has occurred. This is the exercise undertaken by both Mr Sutton and Bencard 1, each of which used default rates and probability of loss. As such, the FTT 's approach to the evidence and the conclusions reached cannot be impugned.

103. Bencard 2 is fundamentally inconsistent with the statutory language and structure. It is predicated on a series of assumptions, namely: (i) non-payment of the termination sum; (ii) insolvency of FF; (iii) absence of any recovery in insolvency; and (iv) insolvency of FBSav and consequent inability to perform under the guarantee. These assumptions go beyond anything required or permitted by paragraph 90(2). The statute requires only that payments are "not made in accordance with [the lease's] terms"; it does not require, or permit, an assumption that (for example) all relevant obligors are insolvent or that no recovery is possible.

104. Bencard 2 gives no operative meaning to the word "risk". By assuming total failure and measuring only the amount of loss, the methodology eliminates the probabilistic element which is central to the statutory definition of non-compliance risk and produces results which are internally incoherent and inconsistent with the legislative purpose.

105. Bencard 2 also ignores the evidence of both experts that the involvement of FF and the FBSav Guarantee materially reduced the likelihood of loss. As paragraphs 89 to 91 are directed at identifying arrangements that reduce the lessor's exposure to loss it is self-evidently wrong and contrary to the intention of Parliament that the effect of guarantees and equivalent risk-reducing provisions are excluded from consideration.

106. The Appellants' reliance on paragraph 91 and on extrinsic materials was rejected by HMRC. Paragraph 91 is concerned with identifying categories of excepted security and does

not alter the definition of non-compliance risk in paragraph 90(2). Nor do the external materials support the introduction of assumptions of total insolvency or total loss.

Discussion

107. We agree with HMRC and do not consider that the FTT erred in law as contended under Ground 3.

108. We agree with the FTT's reasoning and need not repeat it here.

109. The statutory language chosen by Parliament in its definition of non-compliance risk is "a risk that a loss will be sustained by a person if payments under the [Paragraph 89 Lease] are not made in accordance with its terms." The context for that definition is provided by the rationale for the TTR and in particular Part X of Schedule 22, informed by the concerns raised in the consultation relating to the introduction of TTR together with ENFB00 and ENFB03 (as set out in paragraph 60 above).

110. Considering the statutory language, in context, we note the choice by the drafter of "a risk", "a loss" and "if payments…are not made". We consider it clear that the defined term requires an assessment of the level of uncertainty or probability of a person incurring some loss in circumstances in which payments are not made. The Appellants' interpretation effectively seeks to ignore or severely constrain the reference to "a risk" and seeks to substitute the generic and indeterminate reference to "a loss" with a specific and defined loss. The application of the statutory language to the circumstances assumed by Bencard 2 to be the only ones which could give rise to non-payment completely ignores that there could be temporary or partial non-payment. In response to questioning, Mr Ghosh acknowledged that such an approach was "quite primitive", but we would go further and say that it is a clear indication that it is wrong.

111. The Appellants' interpretation carries the consequence that capital allowances would rarely, if ever, be excluded under paragraph 90 where an intermediate leasing party were a bank or a subsidiary of a bank, despite the accepted position of Mr Bencard that the use of such arrangements do, as a matter of fact, materially reduce the possibility of exposure to loss in circumstances where the use of a bank counterparty was intended to have that effect. That would in our view be an absurd result.

112. For these reasons, the appeal under Ground 3 is dismissed.

GROUND 1: THE REDUCTION IN NON-COMPLIANCE RISK MUST BE MEASURED AGAINST AN ASSUMED RISK OF LOSS OF 100%

113. Before the FTT, the expert evidence was that the actual risk of non-compliance in relation to a direct lease to Vroon (a BB-rated shipping company) was between 15.3% (per Bencard 1) and 25.6% (per Mr Sutton).

114. So, in determining whether or not the interposition of a bank as a lessee and the existence of the FBSav Guarantee reduced "the greater part" of that risk, it might be thought obvious that this required the FTT to determine whether the non-compliance risk with those "provisions" was less than 7.65% (per Bencard 1) or 12.8% (per Mr Sutton).

115. However, before the FTT and in this appeal, the Appellants argue that the reduction in non-compliance risk should have been made against a starting point of 100%.

116. It will not escape the reader who has persevered to this point in the decision that on the Appellants' construction, if (as in this case) the actual risk of non-compliance before defeasance is 50% or less, no defeasance arrangements could ever reduce "the greater part" of the risk, because they could never reduce it by more than 50 percentage points.

Appellants' submissions

117. The Appellants submit that the FTT adopted an impermissible methodology by assessing the reduction in risk as a proportion of an already reduced level of risk, rather than by reference to the total non-compliance risk.

118. The reduction in non-compliance risk must be measured by reference to the total potential loss under the Paragraph 89 Lease. The statutory concept of "risk of loss" is anchored to the entirety of the loss which may be suffered, and the removal of risk must therefore be assessed against that totality. On that basis, the appropriate comparator is a notional position in which 100% of the relevant loss is exposed, and the question is whether the effect of the provisions is to remove more than half of that total exposure.

119. The Appellants acknowledged that, on their approach, paragraph 90 would have no practical application in cases where the underlying risk associated with the lessee was below 50%. They submitted that this consequence reflects the statutory design and avoids what they characterised as arbitrary or "cliff edge" outcomes.

120. The FTT's approach involves identifying a level of risk which has already been reduced by other features of the arrangements and then asking whether the impugned provision removes more than half of that residual risk. This approach is wrong in law because it changes the statutory comparator and risks producing arbitrary outcomes. As demonstrated by the FTT's own example at [193] – [199] a *de minimis* reduction in risk is capable of satisfying the statutory test and producing a cliff edge.

121. The Appellants claimed their approach was supported by the structure of paragraphs 90 and 91 in that paragraph 91 requires certain categories of provision to be disregarded altogether. They contend that the FTT's approach impermissibly allows such features to influence the baseline against which the "greater part" test is assessed, thereby distorting the statutory exercise.

122. On the Appellants' case, once the correct approach is adopted, the impugned provisions in the present case do not remove more than 50% of the total non-compliance risk.

HMRC's submissions

123. HMRC submitted that the statutory exercise requires a comparative assessment of the non-compliance risk before and after the introduction of the relevant provision or provisions. They say that the statutory starting point is the "non-compliance risk which, apart from that provision, would fall on the lessor". That requires the identification of the actual level of risk inherent in the transaction in the absence of the provision, rather than to proceed by reference to any notional or hypothetical maximum level of risk.

124. On that basis, HMRC contend that the correct approach involves identifying: (i) the non-compliance risk which would arise absent the provision; and (ii) the reduced level of risk once the provision is considered, and then (iii) determining whether the reduction represents the removal of more than half of the former.

125. The Appellants' approach finds no support in the statutory language and mischaracterises the nature of the risk with which paragraph 90 is concerned, which is the real, probability-weighted non-compliance risk arising on the facts of the arrangements.

126. The Appellants' approach would render paragraph 90 largely ineffective in practice. In the context of commercial ship leasing arrangements of the kind in issue, the level of non-compliance risk will ordinarily be materially below 50%. If the Appellants' construction were correct, the statutory test would rarely, if ever, be satisfied.

Discussion

127. The FTT considered that the assessment of whether "provisions" other than exempted securities in the Paragraph 89 Lease had the effect of removing "the greater part" of the Appellants' non-compliance risk required a structured comparison between the Paragraph 89 Lease with and without the provisions which defeased the risk. In that context both Bencard 1 and Mr Sutton calculated a reduction in risk between the undefeased and defeased Paragraph 89 Lease by an amount which represented the greater part of the risk.

128. The FTT rejected the submission that the exercise involved comparison with a hypothetical 100% risk position or what Mr Ghosh described as a "subtraction approach". Instead, the starting point was the actual level of non-compliance risk arising under the Paragraph 89 Lease: [189] – [193].

129. The FTT further held that the comparative exercise did not use as its starting point the risk in the Paragraph 89 Lease encompassing any reduction arising from an excepted security: [198] – [199].

130. We have no doubt that the FTT reached the right conclusion.

131. Ground 1 seems to us to proceed on two alternative bases. First, it is said that, properly construed, paragraph 90(1) requires a determination of whether the impugned provisions remove more than 50% of a notional total non-compliance risk treated as 100%. Alternatively, it is said that the FTT erred by assessing the effect of the relevant provisions against a baseline of risk which had already been reduced by other features of the arrangements.

132. In our view, the first of those submissions cannot stand independently of the Appellants' case under Ground 3. It depends upon the premise that, in the event of non-payment under the Head Lease, the Appellants would face a 100% probability of total loss. For the reasons we have given in rejecting Ground 3, that premise is unsustainable. The statutory concept of "non-compliance risk" requires an assessment of risk in the sense of probability and does not permit the assumption of total loss divorced from the likelihood of default. It follows that the Appellants' attempt to construct a notional baseline of 100% risk is misconceived.

133. To the extent that the Appellants contend that the phrase "the greater part" in paragraph 90(1) can only be given effect by reference to a fixed benchmark of 50% of the total risk, we do not accept that submission. The statutory language directs consideration of whether the effect of the relevant provision or provisions is to remove "the whole, or the greater part of, any non-compliance risk". We agree with HMRC that, both as a matter of ordinary language and purposive construction, that formulation requires a comparative assessment of two states of affairs: the level of non-compliance risk borne by the lessor in the absence of the relevant provisions, and the level of that risk once those provisions are in place. That comparative exercise is inherently quantitative in nature. The concept of "the greater part" necessarily involves an assessment of proportion, even where the base level of risk is itself relatively low. There is no warrant in the statutory language for substituting a hypothetical or abstract baseline for the actual level of risk arising on the facts of the arrangements. Nor does the legislation suggest that Parliament intended to confine the scope of paragraph 90 to cases in which the initial non-compliance risk exceeded some fixed threshold.

134. To accept the Appellants' construction would, in our judgment, produce results which are inconsistent with both the purpose and practical operation of the provision. As we have said, on the evidence before the FTT, the level of non-compliance risk associated with a BB-rated shipping counterparty was in the region of 15.3% to 25.6%. There was no evidence that commercial shipping leases would ordinarily be entered into where the probability of non-payment exceeded 50%, and such a proposition is in our view inherently implausible. A

construction of paragraph 90 which depends for its application upon an initial risk level exceeding 50% would render the provision almost entirely devoid of practical effect in respect of shipping leases to tonnage tax companies, i.e. in the very class of transactions to which it is specifically directed.

135. We also reject the submission that the absence of a fixed 50% threshold renders the provision arbitrary or produces an impermissible "cliff edge". Any test which turns on whether a specified proportion of a given quantity has been exceeded will necessarily yield outcomes on one side of the line or the other. That does not render the test irrational or unfair. It reflects the use by Parliament of a mathematical or proportional standard. The fact that relatively small differences in the assessed level of risk may determine the outcome is an inherent consequence of that legislative choice.

136. For the purposes of the present appeal, in light of our conclusions in relation to the other grounds we do not need to determine whether the level of non-compliance risk in the absence of impugned provisions should take account of excepted securities. We consider this to be a matter more appropriately determined in a case where the point matters to the outcome of the appeal.

137. On the evidence available to the FTT in the form of Bencard 1 and Mr Sutton's expert opinion, the impugned provisions reduced the risk faced by the Appellants under the Paragraph 89 Leases by more than 50% and thereby the greater part.

HMRC RESPONSE ISSUE

138. Our decision to refuse the appeal on all grounds advanced by the Appellants means that we do not need to consider HMRC's Response Issue. The issues which it raises are, in our view, best dealt with in an appeal where the point is dispositive, and we express no view on it.

DISPOSITION

139. For the reasons stated, we dismiss the Appellants' appeal on all grounds.

JUDGE THOMAS SCOTT
JUDGE AMANDA BROWN KC

Release date: 7 August 2026