[2018] UKUT 0316 (TCC)

Appeal numbers: UT/2016/0198,
UT/2016/0208

CORPORATION TAX – derivative contracts – issue of bonus A Shares carrying a right to a dividend transferring 95% of economic benefit of financial options – derecognition of financial asset (IAS 39) – whether the accounting debit consequent upon derecognition fairly represents for the accounting period in question losses which arise to the company from its derivative contracts – FA 2002, Sch 26 – whether transfer pricing provisions were applicable – ICTA, Sch 28A; FA 2002, Sch 26, para 31A – whether requirements of FA 2002, para 15 must be met in a case where para 25A applies

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE UNION CASTLE MAIL STEAMSHIP COMPANY LIMITED — **Appellant**

- and -

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

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS — **Appellants**

- and –

THE UNION CASTLE MAIL STEAMSHIP COMPANY LIMITED — **Respondent**

TRIBUNAL: MR JUSTICE FANCOURT
JUDGE ROGER BERNER

Sitting in public at The Royal Courts of Justice, Rolls Building, Fetter Lane, London WC2 on 25 – 27 June 2018

Jonathan Peacock QC and Sarah Black, instructed by Deloitte LLP, for Union Castle

Julian Ghosh QC and Ruth Jordan, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for HMRC

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DECISION

Introduction

1. This is the decision on appeals by both parties from the decision of the First-tier Tribunal (Tax Chamber) ("FTT") released on 27 July 2016 concerning the application of the derivative contracts code for computing corporation tax in Schedule 26 to the Finance Act 2002 ("FA 2002"). The FTT's decision is published at [2016] UKFTT 0526(TC).

2. The Union Castle Mail Steamship Company Limited ("Union Castle") is a UK resident company and a wholly-owned subsidiary of an approved and publicly quoted investment trust company, Caledonia Investments plc ("Caledonia"). The appeals concern an amendment made by HMRC to Union Castle's corporation tax return for its accounting year ended 31 March 2009. By a closure notice dated 23 November 2012, HMRC disallowed a deduction of £39,149,128 that had been claimed by Union Castle for that period.

3. The claimed deduction related to a debit arising from the "derecognition" in Union Castle's accounts of a financial asset (or part thereof), namely cash flows from certain FTSE-based derivative contracts.

4. Before the FTT, Union Castle's appeal against the closure notice was designated as a lead case for two other appellants, Ladbrokes Group Finance PLC ("Ladbrokes") and IG Finance Five Limited. The issues to be determined by the FTT were identified by directions made under Rule 18 of the Tribunal Procedure (First Tier Tribunal) (Tax Chamber) Rules 2009 ("the FTT Rules") so as to include one issue that arose only in relation to Ladbrokes' appeal. That issue has been referred to and we refer to it below as the Gateway Issue.

5. The effect of the FTT's decision was that Union Castle's appeal against the closure notice could not succeed and was dismissed, but the Gateway Issue was decided in favour of Ladbrokes, with the result that its appeal would succeed. With permission of the FTT in each respect, Union Castle has appealed the FTT's decision to dismiss its appeal and HMRC have appealed the FTT's decision on the Gateway Issue.

6. In Union Castle's appeal there was, effectively, a single ground of appeal, namely that the FTT was wrong to hold that the debit of £39,149,128 arising from the derecognition of the derivatives contract was not a "loss" within the meaning of paragraph 15 of Schedule 26.

7. In its Response to Union Castle's appeal, HMRC gave reasons why the FTT was correct in its conclusion on the "Loss" issue and further contended that its decision to disallow Union Castle's appeal against the closure notice should be affirmed on additional grounds, namely:

(a) if there was a "loss" for the purposes of Schedule 26, it did not "arise from" the derivatives contract and the FTT erred in finding that it did (the "Arise From" Issue);

(b) if there was a loss, the requirement that the debit "fairly represents" a loss arising from derivative contracts was not satisfied and the FTT erred in finding that it was (the "Fairly Represents" Issue); and

(c) the issue of shares by Union Castle was a provision falling within the scope of the transfer pricing rules in Schedule 28AA ICTA 1988 and the effect of applying the arm's length price to the issued shares would be to reduce to nil the amount deductible for the debit ("the Transfer Pricing Issue").

8. The FTT had decided each of these issues in favour of Union Castle and against HMRC, though HMRC nevertheless succeeded on the prior issue of whether or not there was a "loss" at all. HMRC's Response set out in detail the arguments that it would advance on each of these three issues.

9. By its Reply to HMRC's Response, Union Castle contended that HMRC was not entitled to seek to rely on the Transfer Pricing Issue without seeking and obtaining permission to appeal the FTT's conclusion on that point. In case that was wrong, Union Castle set out the grounds on which it contended that the Tribunal had reached the right decision on that issue.

The factual background

10. The relevant facts were not in dispute before the FTT or before us. The FTT set out in its decision the entirety of a Statement of Agreed Facts. For present purposes, the following matters (taken from that Statement) will suffice to explain the circumstances in which HMRC disallowed the claimed deduction:

(1) Prior to 21 November 2008 Union Castle had issued share capital consisting of 502 shares of £1 each, fully paid, held by Caledonia.

(2) From about May 2007, the board of Caledonia wished to implement a hedging strategy, using put options against a FTSE index. The board was concerned about a possible substantial fall in UK equity markets.

(3) The board was concerned that purchase of such put options might prejudice Caledonia's investment trust status. Accordingly it was envisaged that Union Castle might purchase the put options instead.

(4) Between 20 June and 31 December 2007, five FTSE put options at an aggregate cost of £10 million were acquired by Union Castle, and a further put option was acquired in January 2008 at a cost of £2 million.

(5) In July 2008, accounting guidance for investment trusts and venture capital trusts clarified their right to invest in derivatives, such that it appeared that Caledonia could safely hold such investments in its own name.

(6) During the financial year ending 31 March 2009, some of the put options were exercised and further put options were purchased. As at 31 October 2008 Union Castle held three put options and three put spreads ("the Contracts").

(7) On 19 November 2008, Caledonia's audit committee considered novating the Contracts from Union Castle to Caledonia but realised that this would crystallise a tax charge in Union Castle owing to the current value of the Contracts. The committee therefore considered the possible issue by Union Castle of a new kind of share capital to Caledonia with dividend rights, whereby the economic benefit of the Contracts would effectively be transferred to Caledonia. They noted that this would oblige Union Castle to write off the value of the Contracts, thereby crystallising a tax loss.

(8) On November 2008, Union Castle made a bonus issue to Caledonia of 5020 "A Shares", ten for every one existing ordinary share held by Caledonia.

(9) The A Shares carried a right to receive a dividend equal to 95% of the cash flows arising on the close-out of the Contracts, such dividend to be paid within five business days following receipt by Union Castle of the cash flows.

(10) As a consequence of issuing the A Shares, Union Castle was required to "derecognise" 95% of the value of the Contracts for accounting purposes, amounting to £39,149,128.

(11) Between January and August 2009 Union Castle closed out the Contracts for aggregate proceeds of £25,042,545 and paid dividends to Caledonia in a sum equal to 95% of those cash flows.

(12) On the issue of the A Shares, the following debits and credits were recognised by Union Castle:

Cr Financial asset £39,149,128

Dr income statement £39,149,128

Cr share capital £5,020

Dr share premium £5,020

(13) The A Shares were added to Caledonia's investment ledger as a new security, with no cost attributed, but they were ascribed at fair value, reflecting the "pass-through" right to 95% of the future cash flows from the derivatives. Caledonia did not include an entry in its income statement, but reallocated a part of the fair value from the Ordinary Shares in Union Castle to the A Shares.

(14) Union Castle agreed for the purpose of the proceedings that its accounting treatment in accordance with GAAP should more appropriately have debited the value of the cash flows to the statement of changes in equity rather than to income.

The Relevant Legislation

11. The references in the following paragraphs to Schedule 26 FA 2002 are to its provisions as they were and applied during the tax year 2008-09.

12. Paragraph 1(1) states:

> "For the purposes of corporation tax all profits arising to a company from its derivatives contracts shall be chargeable to tax as income in accordance with this Schedule."

5 13. Paragraph 1(2) provides that Schedule 26 is the exclusive provision for charging such profits to corporation tax.

14. Paragraph 2 defines "derivative contracts" for these purposes, and the definition includes options, futures and contracts for differences. There is no dispute that the Contracts are treated as derivatives for accounting purposes and that the relevant 10 accounting standard is Financial Reporting Standard (FRS) 25.

15. Paragraph 14 provides (so far as material):

> "(1) For the purposes of corporation tax the profits and losses arising from the derivative contracts of a company shall be computed in accordance with this paragraph using the credits and debits given for 15 the accounting period in question by the following provisions of this Schedule."

16. The remainder of paragraph 14 then makes different provision depending on whether or not the company is a party to a derivative contract for the purposes of a trade carried on by it or otherwise.

20 17. Paragraph 15 of Schedule 26, which is central to the disputed issues, provides (so far as material):

> "(1) The credits and debits to be bought into account in the case of any company in respect of its derivative contracts shall be the sums which, when taken together, fairly represent, for the accounting period in 25 question -
>
> (a) all profits and losses of the company which (disregarding any charges or expenses) arise to the company from its derivative contracts and related transactions; and
>
> (b) all charges and expenses incurred by the company under or for 30 the purposes of its derivative contracts and related transactions.
>
> ….
>
> (7) In this Schedule "related transaction", in relation to a derivative contract, means any disposal or acquisition (in whole or in part) of rights or liabilities under the derivative contract.
>
> 35 ….
>
> (9) This paragraph has effect subject to the following provisions of this Schedule."

18. Paragraph 17A(1) provides:

> "Subject to the provisions of this Schedule (including in particular, 40 paragraph 15(1)), the amounts to be brought into account by a

company for any period for the purposes of this Schedule are those that, in accordance with generally accepted accounting practice, are recognised in determining the company's profit or loss for the period."

19. Paragraph 17B(1) provides:

5 "Any reference in this Schedule to an amount being recognised in determining a company's profit or loss for a period is to an amount being recognised for accounting purposes -

(a) in the company's profit and loss account or income statement,

(b) in the company's statement of recognised gains and losses or
10 statement of changes in equity, or

(c) in any other statement of items brought into account in computing the company's profits and losses for that period."

20. Part 6 of Schedule 26 contains special computational provisions. Of these, paragraph 25A is headed "Debits and credits recognised in equity or shareholders'
15 funds" and states:

"Where in accordance with generally accepted accounting practice a debit or credit for a period in respect of a derivative contract of a company-

(a) is recognised in equity or shareholders' funds, and

20 (b) is not recognised in any of the statements mentioned in paragraph 17B(1),

the debit or credit shall be brought into account for that period for the purposes of this Chapter in the same way as a debit or credit that, in accordance with generally accepted accounting practice, is brought into
25 account in determining the company's profit or loss for that period."

21. Paragraph 31A of Schedule 26 creates a link between the transfer pricing provisions of Schedule 28AA of the Income and Corporation Taxes Act 1988 ("ICTA") and the derivative contracts code in Schedule 26. It provides that Schedule 28AA has effect so as to require credits or debits relating to amounts treated as an
30 amount of profit or losses under Schedule 28AA to be brought into account in the same way as actual amounts of profits or losses would be brought into account under Schedule 26.

22. Paragraph 1 of Schedule 28AA sets out the basic rule on transfer pricing, as follows:

35 "(1) This Schedule applies where-

(a) provision ("the actual provision") has been made or imposed as between any two persons ("the affected persons") by means of a transaction or series of transactions, and

(b) at the time of the making or imposition of the actual provision -

(i) one of the affected persons was directly or indirectly participating in the management, control or capital of the other; or

(ii)….

(2) Subject to paragraphs 5A, 5B, 8, 10 and 13 below, if the actual provision-

(a) differs from the provision ("the arm's length provision") which would have been made as between independent enterprises, and

(b) confers a potential advantage in relation to United Kingdom taxation on one of the affected persons, or (whether or not the same advantage) on each of them,

the profits and losses of the potential advantaged person or, as the case may be, of each of the potentially advantaged persons shall be computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision."

23. In Schedule 28AA, "transaction" includes arrangements, undertakings and mutual practices, whether or not they are or are intended to be legally enforceable (para 3(1)), and a person directly participates in the management, control or capital of another person if that other person is at that time a body corporate or partnership and controlled by the first person (para 4(1)).

24. Paragraph 5(1) of Schedule 28AA provides:

"For the purposes of this Schedule the actual provision confers a potential advantage on a person in relation to United Kingdom taxation wherever, disregarding this Schedule, the effect of making or imposing the actual provision, instead of the arm's length provision, would be one or both of the following, that is to say-

(a) that a smaller amount (which may be nil) would be taken for tax purposes to be the amount of that person's profits for any chargeable period; or

(b) that a larger amount (or, if there would not otherwise have been losses, any amount of more than nil) would be taken for tax purposes to be the amount for any chargeable period of any losses of that person."

25. By virtue of paragraph 2(1) of Schedule 28AA, that Schedule is to be construed in such manner as best secures consistency between the effect given to paragraph 1 and the effect which "in accordance with the transfer pricing guidelines, is to be given, in cases where double taxation arrangements incorporate the whole or any part of the OECD model, to so much of the arrangements as does so". The OECD model is, for these purposes, Article 9 of the Model Tax Convention on Income and on Capital published by the OECD, and the "transfer pricing guidelines" are for these purposes the documents published by the OECD at any time before 1 May 1998 as part of their Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The relevant Guidelines for this purpose are those published by the OECD in July 1995.

26. Paragraph 13 of Schedule 28AA provides (so for as material):

> "(1) … nothing in this Schedule shall be construed as affecting -
>
> (a) the computation of the amount of any capital allowance or balancing charge made under the Capital Allowances Act; or
>
> (b) the computation in accordance with the 1992 Act of the amount of any chargeable gain or allowable loss …"

Issue 1: Loss

27. The FTT decided that there was no loss arising to the company (within the meaning of paragraph 15(1)(a) of Schedule 26) in relation to the Contracts held by Union Castle at the time of the derecognition of 95% of their benefit. It summarised the argument advanced on behalf of Union Castle to substantiate a loss of 95% of an asset as being that before derecognition upon issue of the A Shares Union Castle held 100% of the economic benefit of the Contracts but after derecognition only 5%. The Tribunal stated that it preferred HMRC's argument that there was no loss on the basis that Union Castle remained entitled to receive the cash flows under the Contracts and chose to give most of those cash flows away. Union Castle was entitled to exactly the same amount under the Contracts as it was before the issue of the A Shares and there was therefore no diminution in the resources of Union Castle and therefore no real loss.

28. Paragraphs 17A and 17B of Schedule 26 specify that the amounts to be brought into account are those that are recognised in GAAP-compliant accounts in determining the Company's profit or loss for the accounting period, whether recognised in the profit and loss account, the statement of recognised gains and losses or the statement of changes in equity. It is common ground that the starting point for the computation of corporation tax is therefore the accounting treatment of relevant profits and losses under derivative contracts. It is also accepted by HMRC that the treatment in the accounts is subject to the further controls provided by paragraph 15 of the Schedule, in that any profits or losses must "arise from" derivative contracts and related transactions, and further that the sums brought into account must "fairly represent" all profits and losses so arising in an accounting period. Given that the starting point is GAAP-compliant accounting treatment of relevant profits and losses and that the question under paragraph 15 is whether these "arise from" derivative contracts and related transactions, it might be thought that there is little more that needs to be read into the meaning of the words "profits" and "losses" in that paragraph.

29. However, HMRC argues that Union Castle has suffered no "loss" within the meaning of paragraph 15 because, despite derecognition, it still had the derivative contracts. It had entered into a separate transaction and agreed to declare a dividend of an amount equal to 95% of the proceeds of the Contracts when they were closed out at some later time. IAS 39, which is agreed to be the relevant accounting standard, requires that the transaction be treated in Union Castle's accounts as if it were a transfer of 95% of the benefit of the derivative, but (contends HMRC) it is not in reality a transfer and so is not a real loss, merely an accounting loss.

30. HMRC may be right that the issue of the A Shares was not a loss in relation to the Contracts, at least in common parlance, and that the accounting debit arose from the derecognition required by IAS 39 as a consequence of the issue of the A Shares. But the question is not what is generally meant by "loss", or whether the loss was a loss of rights in relation to the Contracts. Whether any loss *arises from* derivative contracts is a separate issue.

31. The question here is one of the contextual meaning of "losses" in paragraph 15(1)(a) of Schedule 26, where the credits and debits to be brought into account in computing profits and losses are (by virtue of paragraph 17A) those recognised in GAAP-compliant accounts. The focus of any loss, in accounting terms, is on a reduction in the overall value (or net worth) of the company. A loss arises for accounting purposes on derecognition because the economic value to the company of the Contracts no longer exists (as to 95% of the value in Union Castle's case) and the company's worth has gone down.

32. While it is accepted that "losses" in paragraph 15 has a legal and not purely an accounting meaning, its legal meaning is driven by the context. The phrase to be construed as a whole is "profits and losses … which arise to the company from its derivative contracts and related transactions". The meaning of "profits" and "losses" is coloured by the fact that, by virtue of paragraphs 17B and 25A, the recognition of an amount in a statement of changes in equity or in equity or shareholders' funds is capable of being a "profit" or "loss", albeit (and subject to the Gateway Issue) subject to the operation of paragraph 15 itself.

33. It seems to us that the FTT was influenced in concluding that there was no loss by its own earlier decision in *Abbey National Treasury Services plc v Revenue and Customs Commissioners* [2015] SFTD 929, on which HMRC relied. That too was a case concerned with the derivative contracts code in Schedule 26. The facts were very similar: ANTS was a party to valuable interest rate swaps and issued one thousand tracker shares to its parent company, entitling the latter to receive dividends in relation to the swaps cash flows, though legal ownership of the swaps remained with ANTS. The swaps cash flows to which the dividend rights were linked were de-recognised as assets in ANTS's accounts, following the rules in IAS 39. The corresponding debit was taken to equity and recognised as a dividend in ANTS's statement of changes in equity.

34. The Tribunal in that case accepted HMRC's argument that for legal purposes ANTS was in exactly the same position that it had always been, as regards the swaps, but had an equal and opposite obligation to pay away receipts from the swaps by way of dividend. ANTS therefore did not have a debit which could properly be recognised under Schedule 26 - the derecognition debit in its accounts was not a loss to which Schedule 26 applied. The Tribunal further held that, if it were such a loss, it did not "arise from" a derivative contract but from the issue of the tracker shares.

35. In our judgment, the reasoning of the Tribunal in the *Abbey National* case on the question whether there was a loss within the meaning of paragraph 15 of Schedule 26 was erroneous, leading to the wrong conclusion on whether the debit arising from the

derecognition was a "loss". It is clear from [85] and [86] of the decision that the Tribunal was conflating the meaning of "loss" with the questions of whether a loss "arises from" derivative contracts and whether the accounting treatment fairly represents profits and losses arising from the derivative contracts. Further, the Tribunal appears to have considered that whether the derecognition debit was taken to equity rather than into a profit and loss account made a difference (see [89]). But paragraphs 17A and 17B of Schedule 26 make it clear that there is no relevant difference in this respect between the profit and loss account and a statement of changes in equity.

36. Moreover, the Tribunal in *Abbey National* was focusing on the wrong event, namely the later events of the cash flow into ANTS and the payment of the dividend, rather than the relevant event of the derecognition of the economic benefit of the swaps. ANTS did not choose to pay a dividend at a later time: it did so because it was obliged to do so as from the date of issue of the tracker shares. The loss was incurred at that time, not as a result of a decision at a later time to pay a dividend. The same analysis applies in the case of Union Castle: a loss was incurred upon issue of the A Shares with their dividend rights, not at any later time.

37. In summary, in our judgment the right approach in deciding whether or not there has been a "loss" for the purpose of paragraph 15 of Schedule 26 is to focus on the net worth of the company, as shown in its GAAP compliant accounts. The argument that there was no diminution in value of the derivative contracts is an argument not about loss but from whence that loss arose. The decision in *Abbey National* was right but only on the alternative basis that the loss incurred upon derecognition did not "arise from" derivative contracts; it arose from the issue of the tracker shares. Similarly, in our judgment, in this case HMRC's argument on "loss" is, in substance, an argument that the loss does not "arise from" the derivative contracts.

38. For these reasons, we hold that the FTT was wrong to hold that the debit attributable to the derecognition of 95% of the value of the Contracts was not a "loss" within the meaning of Schedule 26.

Issue 2: "Arise From"

39. The language of paragraph 15 of Schedule 26 itself demonstrates that the words "arise [to the company] from its derivative contracts" are intended to have a different meaning from "in respect of its derivative contracts" and "under or for the purposes of its derivative contracts". Each of these expressions is used in different parts of the paragraph and cannot have been intended to mean the same thing. The words "in respect of" appear to have a broader meaning than either of the other expressions, since credits and debits in respect of a company's derivative contracts include the matters falling within both sub-paragraph (a) and sub-paragraph (b) of paragraph 15(1). Conversely, "arise from" derivative contracts does not mean "are in respect of" or "under" derivative contracts. On the face of it, given the different expressions used, "arise from" bears a narrower meaning and implies a direct causal connection between losses (or profits) and derivative contracts.

40. It is also evident from the language of paragraph 15(1)(a) that profits and losses that arise from "related transactions" do not arise from the derivative contracts themselves. If they did, there would be no need to refer separately to profits and losses arising from related transactions. Since related transactions are defined as disposals in whole or part of rights or liabilities under the derivative contracts, it would be very surprising if the draftsman had assumed that something remoter from the derivatives contracts themselves (viz. an agreement to transfer a sum of money equivalent to the economic benefit of the contracts) was something that "arises from" the derivative contracts. The draftsman would not have made express provision for related transactions, to avoid doubt as to whether these arose from derivative contracts, but then left in doubt whether a more doubtful category of transaction arose from derivative contracts.

41. In our judgment, the specific inclusion of related transactions demonstrates that profits and losses from a disposal or acquisition of rights or liabilities under the derivative contracts is not regarded as "arising from" the derivative contracts themselves. As a matter of contextual analysis therefore, "arise from" appears to mean arises directly from the derivative contact, in a causal sense.

42. The same conclusion is reached on a purposive analysis of the statutory provisions. The provisions as a whole aim to tax the derivative contracts (and related transactions in those derivatives, as defined). They are not concerned with transactions that do not affect the value of the derivatives themselves, even if the value ascribed to such transactions is somehow related to the value of the derivative or its cash flows.

43. A loss arising from the derecognition of an asset as a consequence of the issue of the A Shares, carrying future dividend rights calculated by reference to the cash flow from the Contracts, therefore cannot be a loss "arising from" the Contracts. It arises from the issue of the A Shares, albeit the quantum of the loss depends on a valuation of the derivative contracts at the time of the issue of the shares. That is the relevant causal connection. In this respect, we agree with the reasoning of the Tribunal in the *Abbey National* case, which said (at para 97):

> "In this case no income was assigned from the Swaps, no rights under the Swaps were transferred. The debit arose as made clear by Mr Drummond because of the contractual obligation to pay on the Swap Cash Flows under the Tracker Shares, which had no legal impact on the Swaps at all. This debit might be economically connected to, or related to, the derivative contracts, but it does not arise from those contracts as required by para 15."

44. Both the credit and the debit entries in Union Castle's accounts derived from the same source, namely the issue of the A Shares and the consequential derecognition of 95% of the economic benefit of the derivative contracts. In our judgment, it is artificial and wrong to argue that the debit entry in the accounts was caused by the credit entry in relation to the financial asset and so the loss was directly related to the Contracts.

45. Accordingly, we would uphold the decision of the FTT to dismiss Union Castle's appeal on the basis that the claimed loss of £39,149,128 did not arise to Union Castle from its derivative contracts and related transactions within the meaning of paragraph 15 (1) of Schedule 26.

46. This conclusion makes it strictly unnecessary for us to determine the "Fairly Represents" and "Transfer Pricing" Issues. Nevertheless, having heard detailed argument on these issues, and in case our decision is appealed further, we will express our conclusions on them.

Issue 3: "Fairly Represents"

47. In light of the decisions of the Supreme Court in *DCC Holding (UK) Limited v. Revenue and Customs Commissioners* [2010] UKSC 58; [2011] 1WLR 44 and the Upper Tribunal (Tax and Chancery Chamber) in *GDF Suez Teesside Limited v. Revenue and Customs Commissioners* [2017] UKUT 68 (TCC), the "fairly represents" requirement in paragraph 15(1) of Schedule 26 should not be regarded as a criterion relating merely to attribution or timing of losses and profits. On the other hand, it cannot be regarded as providing a freestanding criterion of fairness by which means the accounting treatment of profits and losses can be reopened. Both the *DCC* and *GDF Suez* cases were decisions on the loan relationships code in the Finance Act 1996, but both sides before us accepted that there was no relevant distinction in terms of meaning between the words in paragraph 15 of Schedule 26 and the comparable words in section 84(1) of the Finance Act 1996, as amended by the Finance Acts 2004 and 2006.

48. Where exactly the line is to be drawn between a narrow attribution and timing function and a criterion of fairness is unclear on the authorities. The *DCC* and *GDF Suez* cases each stands as authority for the proposition that "fairly represents" enables HMRC to prevent a "mismatch" in accounting treatment between the accounts of a parent company and the accounts of its subsidiary in relation to the same transaction. There is no authority that "fairly represents" encompasses any other category of case, though it is arguable that the ability to prevent a "mismatch" may not be limited to cases of parent and subsidiary companies.

49. Accordingly, the question on the authorities as they stand is whether there is any kind of accounting "mismatch" in this case. In our judgment there is none. The issue of the A Shares made no substantial difference in Caledonia's accounts. That is because, subsequently to their issue, the value of the Contracts in those accounts was reflected (as to 95%) in the value of the A Shares and as to 5% in the value of the ordinary shares of Union Castle, whereas before their issue the value was reflected wholly in the value of the ordinary shares. There is nothing surprising about that. Had Caledonia not owned the ordinary shares of Union Castle, there would have been a corresponding increase in its net worth as a result of the issue of the A Shares. The fact that there was no substantial increase is attributable only to the fact that Union Castle was a wholly-owned subsidiary.

50. As it emerged in argument, the "mismatch" for which HMRC argued was that the issue of the A Shares should have been treated as a distribution and accordingly was not an allowable loss at all. But that is not a mismatch in the accounting treatment adopted for the same transaction in the accounts of different companies, as was the case in *DCC* and in *GDF Suez*. HMRC is not seeking to establish any mismatch between economic reality and the tax treatment of the transactions, as was the case in *GDF Suez* (paragraph 103), but is seeking to re-characterise the transaction - a bonus issue of share capital - as a non-allowable distribution. On any view, the "fairly represents" requirement does not entitle HMRC to go that far.

51. HMRC argued, in the alternative, that the transaction should be regarded as Union Castle entering into the Contracts as agent for Caledonia. Not only is that a re-characterisation of the transaction and beyond the scope of what is permitted by the requirement of "fairly represents", but it is exactly the legal effect that Caledonia was concerned (for perfectly proper reasons) to avoid, lest its status as a recognised investment trust be placed at risk. There is no basis for a conclusion that Union Castle was Caledonia's agent in this respect.

52. Accordingly, if (contrary to our decision) the relevant loss did arise from the Contracts, the credits and debits to be brought into account do fairly represent for the accounting year in question all profits and losses of Union Castle which arise from its derivative contracts.

53. We were told by Counsel at the hearing that a further appeal in the *GDF Suez* case has been heard by the Court of Appeal and judgment reserved. It had been our intention to reserve our decision until after that judgment had been given. However, the disposal of this appeal does not turn on the Fairly Represents Issue and, in the light of the particular arguments advanced by HMRC on that Issue, we consider that there is no reason to delay the release of this decision further.

Issue 4: Transfer Pricing

Procedural issue

54. As we have indicated, Union Castle took the point that HMRC should not be permitted to argue this issue, having not obtained permission to appeal, although the issue was fully raised in its Response to Union Castle's appeal. This fully complied with HMRC's obligation to give notice in accordance with Rule 24 of the Tribunal Procedure (Upper Tribunal) Rules ("the UT Rules").

55. The argument that HMRC should have sought permission to appeal on the issue is in our judgment misplaced. In relation to Union Castle's appeal, HMRC were the successful party before the FTT; they could not seek to appeal the FTT's decision, which was to the effect that Union Castle's appeal against the closure notice was dismissed. The FTT's decision on the Gateway Issue (which is the subject of an appeal by HMRC) was separate from Union Castle's appeal, as it did not affect Union Castle.

56. Although the Transfer Pricing Issue was a separate issue that was argued before the FTT, it amounted only to a different basis on which the FTT might have dismissed the appeal against the closure notice in Union Castle's own case. That is because HMRC's argument was that the effect of applying an arm's length price to the A Shares was to reduce to nil the amount deductible in respect of the Contracts under Schedule 26.

57. The relevant authority in this regard is *Secretary of State for the Home Department v EG and NG* [2013] UKUT 00143 (IAC) in which, in the Immigration and Asylum Chamber, the Upper Tribunal said (at [45] and [46]):

> "45. Although section 11 of the 2007 Act extends the right of appeal (with permission and subject to excluded decisions) to an appeal "on any point of law" save for extraordinary cases, a party will not normally be given permission to appeal, and will not be expected to seek permission to appeal, a point that would not make a material difference to the outcome. However that party might still have very good reasons to respond to an appeal by arguing that the First-tier Tribunal should have dismissed or allowed the appeal for reasons other than those given in the Determination or rather for grounds which were unsuccessful in the proceedings that are the subject of the appeal.
>
> 46. Suppose a man seeks entry clearance as a husband and suppose that the Entry Clearance Officer finds that he has not shown that he can be either accommodated or maintained in accordance with the rules. A First-tier Tribunal Judge may decide, arguably wrongly, that the husband can satisfy the accommodation requirements but not the maintenance requirements. In that event the judge would dismiss the appeal. The Entry Clearance Office would have no interest in appealing. He is content with the decision to dismiss the appeal. The husband however may want to challenge the decision. He might want to argue that the decision that he did not satisfy the maintenance requirements was wrong in law and he may be given permission to appeal. In that event the Entry Clearance Officer may well want to argue not only that the decision that the husband did not meet the maintenance requirements was right but that the decision that he did meet the accommodation requirements was wrong. In short, without wanting to appeal the decision, the Entry Clearance Officer may want to rely on a ground that failed before the First-tier Tribunal. Rule 24 permits the Entry Clearance Office to give notice of his intention to raise such a point in a reply. In short rule 24 does have a meaning that does not depend on Ms Dubinsky's premise and we reject the construction that she urged on us. Rule 24 does not create a right of appeal to a party who has not asked for permission to appeal. Rule 24 is not in any way to do with seeking permission to appeal and it is not an alternative to seeking permission where permission is needed. It is to do with giving notice about how the respondent intends to respond to the appeal that the appellant has permission to pursue. If a respondent wants to argue that the First-tier Tribunal should have reached a materially different conclusion then the respondent needs permission to appeal."

58. In this Chamber, the Upper Tribunal in the *GDF Suez* case reached the same conclusion for the same reason.

59. In one sense, HMRC is contending that the FTT should have reached a materially different conclusion, in that it seeks to establish that it should have held that the transfer pricing provisions applied in this case. But that is not the sense in which the Upper Tribunal used those words in the *EG and NG* case, as the context makes clear: the "conclusion" is the ultimate decision of the lower tribunal, in this case to dismiss Union Castle's appeal. Had Union Castle not appealed, HMRC would have had no interest in appealing the FTT's decision in that case and could not have done so. HMRC is therefore only arguing, as respondent to Union Castle's appeal, that the FTT should also have reached the decision that it did for an additional reason. It is not seeking to appeal the FTT's disposition of that case.

60. Had Union Castle not appealed, it would then have been arguable that HMRC should have also applied for permission to appeal the Transfer Pricing Issue as part of its appeal on the Gateway Issue, if it wished to challenge the FTT's conclusion on the Transfer Pricing Issue in connection with its appeal on the Gateway Issue. That is because HMRC would have been the only appellant, and as such all issues which HMRC wished to raise in that respect would have to have been subject to permission to appeal. However, in those circumstances it would not have been necessary for HMRC to have succeeded on the Transfer Pricing Issue; if HMRC were successful on the Gateway Issue, the unappealed conclusion of the FTT in Union Castle's appeal would have sufficed, under Rule 18 of the FTT Rules, to resolve Ladbrokes' appeal. In circumstances where Union Castle has appealed, the Transfer Pricing Issue is thus properly referable to that appeal, and not to HMRC's separate appeal on the Gateway Issue. Accordingly, the Transfer Pricing Issue was properly raised by HMRC in their Response to Union Castle's appeal and there was no requirement for HMRC to have sought permission to appeal.

The substantive Transfer Pricing Issue

61. We turn therefore to the substance of the Transfer Pricing Issue.

62. The FTT decided that the bonus issue of the A Shares did not amount to a "provision" for the purposes of Schedule 28AA ICTA and that consequently no adjustment in this respect could be made. The FTT based that conclusion on what it considered to be a relevant distinction in the OECD Guidelines between shareholder and non-shareholder transactions.

63. The FTT referred, at [75], to the material extract from the OECD Guidelines:

> "7.9 A more complex analysis is necessary where an associated enterprise undertakes activities that relate to more than one member of the group or to the group as a whole. In a narrow range of such cases, an intra-group activity may be performed relating to group members even though those group members do not need the activity (and would not be willing to pay for it were they independent enterprises). Such an activity would be that one group member (usually the parent company

> or a regional holding company) performs solely because of its ownership interest in one or more other group members, ie in its capacity as shareholder. It may be referred to as a 'shareholder activity', distinguishable from the broader term 'stewardship activity' used in the 1979 Report. Stewardship activities covered a range of activities by a shareholder that may include the provision of services to other group members, for example services that would be provided by a coordinating service. These latter types of non-shareholder activities could include detailed planning services for particular operations, emergency management or technical advice (trouble shooting), or in some cases assistance in day to day management.
>
> 7.10 The following examples (which were described in the 1984 Report) will constitute shareholder activities under the standard set forth in paragraph 7.6:
>
> (a) Costs of activities relating to the juridical structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company and costs of the supervisory board;
>
> (b) Costs relating to reporting requirements of the parent company including the consolidation of reports;
>
> (c) Costs of raising funds for the acquisition of its participations.
>
> In contrast, if for example a parent company raises funds on behalf of another group member which uses them to acquire a new company, the parent company would generally be regarded as providing a service to the group member. The 1984 Report also mentioned 'costs of managerial and control (monitoring) activities related to the management and protection of the investment as such in participations'. Whether these activities fall within the definition of shareholder activities as defined in these Guidelines would be determined according to whether under comparable facts and circumstances the activity is one that an independent enterprise would have been willing to pay for or perform for itself."

64. In our judgment, the distinction drawn in the OECD Guidelines between shareholder and non-shareholder activity does not operate as a blanket exclusion from the ambit of "provision" for the purpose of Schedule 28AA of transactions concerning share capital between associated persons. Paragraph 7.9 of the Guidelines is concerned with what is described as a narrow range of cases where an activity is performed by a group company because of its ownership interest in one or more group members, but where that activity is not needed by the other group members and would not be paid for by them if they were independent enterprises. The relevant distinction is that described in paragraph 7.6 of the Guidelines;

> "Under the arm's length principle, the question whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent

> enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity should not be considered as an intra-group service under the arm's length principle."

65. An issue of shares by a subsidiary to its parent company is not in the nature of a transaction, such as those referred to in paragraph 7.9 of the Guidelines, or the examples given in paragraph 7.10, where the activity is performed by one group company because of its ownership interest in another or others. Such an issue may, applying the test in paragraph 7.6, amount to an activity which provides economic or commercial value to the parent company or enhances its financial position such that an independent enterprise would be willing to pay for the share issue. Whether that is the case would depend on the particular circumstances.

66. Nor is there anything in Schedule 28AA itself which would exclude from the ambit of transfer pricing a share issue such as the bonus issue of the A Shares in this case. Paragraph 13 of Schedule 28AA does not amount to an exclusion of capital transactions, or give rise to any inference that such transactions should be excluded. It relates to the nature of the adjustments to taxation that may be made, and not to the nature of the provision which might fall within the ambit of the Schedule. In this case, there is no relevant adjustment whether to capital allowances or chargeable gains. If any adjustment were capable of being made it would be to the charge to corporation tax on income under the derivatives code.

67. We do not accept Mr Peacock's submission that the issue of shares does not bear the character of making or imposing conditions in "commercial and financial relations" as required under Article 9 of the OECD Model Convention. In our judgment, agreeing in this respect with the observations of the Tribunal in the *Abbey National* case (at [101]), that expression should not be narrowly construed; it is clearly wide enough to encompass share issues, which can and do make or impose conditions in both commercial and financial relations. Furthermore, we reject Mr Peacock's submission that the tenor of the OECD Guidelines is to focus on trading relationships; it is clear that debt financing, including debt financing that has a capital or equity character, is within the scope of the transfer pricing rules. There is no reason in principle why share transactions which have an effect on income taxation should not also be included.

68. We would add that we consider that the FTT in this case was also wrong, at [76], to regard the Commentary on Article 9 of the OECD Model as having materially distinguished between debt finance and equity finance. It is not the case, as the FTT supposed it to be, that the Commentary at paragraph 3(b) goes to exclude equity finance from transfer pricing; it does no more than confirm, in the context of thin capitalisation provisions, that Article 9 is wide enough to permit adjustments not only to the rate of interest in debt finance at arm's length but also to re-characterise debt finance in some other way, in particular as a contribution to equity.

69. The decision of the special commissioners in *Ametalco UK v IRC* [1996] STC (SCD) 399, to which we were referred by Mr Peacock and to which the FTT referred at [84], is of no assistance. In that case, which concerned the application of the then domestic transfer pricing rules to certain interest-free loans, it was accepted by the Crown that a subscription for ordinary shares was not within the statutory net. But not only was that a concession which has not been repeated in this case, it was a concession that was based on the particular language of s 770 ICTA as it then applied, as extended by s 773 to "the giving of business facilities of whatever kind". It is of no assistance therefore in the construction and application of Schedule 28AA and the meaning of "provision".

70. Nor in our view can Union Castle derive any assistance from the judgment of the Indian High Court in *Vodafone India Services Pvt Ltd v Union of India and others* (2014) 17 ITLR 209, to which the FTT referred at [85]. In that case it was held that the Indian transfer pricing provisions could not operate to impute a charge to tax on income on an issue of shares by an Indian subsidiary to its non-Indian parent company for a subscription price said to have been below market value. However, that conclusion was not based on any principle that capital transactions such as the issue of shares must be outside the scope of transfer pricing, but on the basis that the relevant Indian statutory provision was confined to computations of income. Share premiums on the issue of shares were capital receipts and not income, and there was no express provision to tax such receipts as income.

71. In this case, by contrast, what is at issue is whether an issue of shares can fall within the meaning of "provision" in Schedule 28AA. There is no limitation in Schedule 28AA, or elsewhere, corresponding to the Indian statutory provisions at issue in *Vodafone*, which can operate to exclude capital transactions generally. In the context of taxation of derivative contracts, paragraph 13 - as we have found - imposes no such limitation.

72. We thus conclude that the FTT erred in law in determining that the bonus issue of the A Shares did not amount to a "provision" for the purposes of Schedule 28AA. Were the Transfer Pricing Issue to have been material, we would have been inclined to remit the case to the FTT to determine, first, whether the actual provision of the issue of the bonus issue of A Shares differed from an arm's length provision that would have been made as between independent enterprises, and, if so, secondly, what if any adjustment might be made in order to reflect the application of the arm's length provision. We are conscious that there are a number of competing arguments in that respect, both legal and factual, and that evidence, including expert evidence, may be required in a given case. As those issues are not material to the outcome of this appeal, and they were not determined by the FTT in this case, we prefer to leave them for consideration in another case where they will be material. We would only say, for the avoidance of doubt, that although we have reached the same conclusion as the Tribunal in *Abbey National* as to the scope of the transfer pricing rules in this context, we express no view on the other conclusions reached by that Tribunal, in particular its conclusion that the comparator transaction in that case was one where no relevant shares had been issued.

Issue 5: the Gateway Issue

73. The Gateway Issue is, as we have described, the subject of a separate appeal by HMRC. It concerns only the Ladbrokes appeal, and not that of Union Castle. The issue is whether debits recognised under paragraph 25A of Schedule 26 are subject to the requirements of paragraph 15 of that Schedule, or whether they can be brought into account otherwise. It arises in relation to Ladbrokes only because the accounting treatment used by Ladbrokes for the debit was to recognise it in equity; it was not recognised in any of the statements mentioned in paragraph 17B(1).

74. In those circumstances, paragraph 25A provides that the debit (or credit, as applicable) is to be brought into account for the relevant period for the purpose of the derivative contracts code "in the same way" as a credit or debit that, in accordance with GAAP, is brought into account in determining the company's profit or loss for that period.

75. The FTT held, at [67], that it was unnecessary in the case of a debit falling within paragraph 25A for the requirements of paragraph 15 to have been met before the debit could be brought into account. It found in this respect that, in the absence of recognition of the debit in any of the statements mentioned in paragraph 17B(1), paragraph 25A fulfils the role played by paragraph 15. The effect of that conclusion is that a credit or debit in respect of a derivative contract of a company which is recognised only in equity or shareholders' funds is brought into the computation of profits and losses without any requirement that the credit or debit fairly represent for the accounting period in question profits and losses which arise from the company's derivative contracts and related transactions.

76. The FTT did not give any reasons for its conclusion on this issue, and with respect we consider that its conclusion is wrong. We do not consider that it can be concluded that paragraph 25A is an alternative provision to paragraph 15. There is nothing in paragraph 25A to suggest such a result. Paragraph 25A does no more than make provision for credits and debits which are not recognised by virtue of paragraph 17B(1). It achieves, in our judgment, nothing more than to equate the position of credits and debits recognised outside the paragraph 17B(1) statements, and in equity or shareholder's funds instead, with those credits and debits which are recognised for accounting purposes in those statements.

77. That construction is reinforced by the requirement, in paragraph 25A, that the debit or credit which is recognised in equity or shareholders' funds and not in any paragraph 17B(1) statement is to be brought into account for the relevant period "in the same way" as a debit or credit that, in accordance with GAAP, is brought into account in determining the company's profit or loss for that period. It is paragraph 15 which determines the way in which credits and debits are to be brought into account by setting the requirements that must be met for sums to be so brought into account.

78. We do not accept Mr Peacock's submission that the expression "in the same way" refers to the operation of paragraph 14 of Schedule 26 and not paragraph 15. Mr Peacock submitted that paragraph 14 specifies that the profits and losses of a

company are to be computed in accordance with that paragraph, and that it is paragraph 14 that actually brings the credits and debits into account, with the following paragraphs (including paragraph 15) simply determining what those credits and debits are. Mr Peacock argued that the "way" in which credits and debits are brought into account is the determination in paragraph 14 whether those debits and credits should be brought into account as receipts and expenses of a trade (paragraph 14(2)) or as non-trading credits and debits (paragraph 14(3)).

79. We do not agree. The requirement under paragraph 25A that the provisions should operate "in the same way" is a requirement referable to the bringing into account of credits and debits. That is the purpose of paragraph 15: paragraph 15(1) expressly sets out the credits and debits to be brought into account. Paragraph 14, by contrast, is concerned with the computation of profits and losses using those credits and debits which have, by virtue of paragraph 15, been brought into account. Had it been intended to take the credits and debits recognised in equity or shareholder's funds, and not in a paragraph 17B(1) statement, directly to the computation of profit and loss, without needing to meet the paragraph 15 tests as to the bringing into account of the credit or debit, the legislation could have said so, but it would have had to have been drafted in very different terms.

80. In reaching its conclusion, the FTT accepted the argument for Union Castle, repeated before us by Mr Peacock, that paragraph 25A essentially performs the same function as paragraph 15. That submission takes as its premise that paragraph 15 performs only two roles in those cases where the amount in question is recognised in a paragraph 17B(1) statement: first to set out that the credits and debits to be brought into account have to be in respect of derivative contracts; and secondly that they have to be appropriate to the right accounting period. On that basis it is argued that paragraph 25A performs the same functions and that it would be superfluous for paragraph 15 to require to be satisfied too.

81. We consider that those submissions are based on a false premise. Paragraph 15 does not have such a limited application. It operates as the fundamental limitation on the nature of the credits and debits that are to be brought into account in respect of a company's derivative contracts. Not every debit or credit in respect of those contracts falls to be brought into account. To be brought into account paragraph 15 requires that the credits and debits must fairly represent for the accounting period in question either profits and losses of the company which arise to the company from its derivative contracts and related transactions or charges or expenses incurred by the company for the purposes of its derivative contracts and related transactions. Paragraph 25A cannot fulfil the role of paragraph 15. Indeed, an analysis of the operation of the two provisions supports the conclusion that they are not mutually exclusive but must operate in tandem.

82. It is in our view nothing to the point that paragraph 15(9) provides that paragraph 15 has effect "subject to the following provisions of this Schedule". That cannot be regarded as having the effect that paragraph 15 is displaced by all or any of the succeeding provisions of Schedule 26. It merely confirms that paragraph 15 is not an exhaustive provision. It operates in conjunction with the other provisions of the

Schedule, such as paragraphs 17A and 17B. In our judgment, for the reasons we have given, it operates equally in conjunction with paragraph 25A.

83. We reach our conclusion in this respect as a matter of the natural and ordinary meaning of the relevant statutory provisions. It is not in our view necessary to identify any purpose as an aid to construction. However, we consider that this construction is supported by the clear purpose of the derivatives code, which is to take into account in computing profits and losses for corporation tax purposes only those credits and debits which meet the requirements of paragraph 15. That purpose cannot sensibly be regarded as confined to credits and debits recognised in the paragraph 17B(1) statements and no different purpose can be discerned for credits and debits whose accounting treatment takes them outside those statements and instead recognises them in equity or shareholders' funds. There is no logical purpose in a more favourable and less stringent treatment being afforded to either credits or debits by reason of their particular accounting treatment. That would have the effect that a debit which, although in respect of a derivative contract, does not arise from a derivative contract, would be afforded relief. It would also have the equally perverse effect that such a credit, not arising from a derivative contract, would fall within the taxing provisions of the derivatives code. Properly construed, in our view, the provisions of Schedule 26 do not have that effect.

Decision

84. In light of our conclusion on the Arise From Issue, the appeal of Union Castle is dismissed.

85. As we have found that the FTT made an error of law in respect of the Gateway Issue, we allow the appeal of HMRC in that respect and we set aside the decision of the FTT in relation to that issue.

Per curiam

86. The lead case direction made by the FTT on 25 February 2015 expressly acknowledged that what has become known as the Gateway Issue was not relevant to the lead case appellant, Union Castle, but only to one of the related appeals: Ladbrokes. In our view, it was not appropriate for such a direction to have been made. Where the common or related issues are not all material to the lead case, but are material to one or more of the related cases, the proper course is for the FTT to designate more than one lead case, so that there is at least one appeal before the Tribunal in which each issue is live.

87. It is in our view unsatisfactory for an issue which is material only to a party to one appeal to be dealt with as part of another appeal. The Tribunal must have jurisdiction over an appeal in which that issue is live. Although Rule 18 of the FTT Rules operates to bind related parties in relation to the common or related issues, Union Castle's appeal did not give rise to the Gateway Issue that arose in the Ladbrokes appeal. That issue was peculiar to Ladbrokes, and accordingly it should have been addressed by the FTT only in Ladbrokes' appeal. If the Gateway Issue had

been common to a number of related cases, the FTT should have designated one of those related cases as a lead appeal, either instead of or alongside Union Castle's appeal.

5

MR JUSTICE FANCOURT
UPPER TRIBUNAL JUDGE ROGER BERNER

RELEASE DATE: 02 OCTOBER 2018

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Corrected under Rule 42 on 24 October 2018