TC04590

Appeal number: TC/2013/08160

Corporation tax –loan relationships- transfer of contingent debt asset – no profit recognised in accounts – s 84 Finance Act 1996 – "fairly represents" profits – whether accepted accounting method – impact of override in s 84 – held – taxpayer's accounts GAAP compliant – no alternative set of GAAP compliant accounts – FRS 5 substance approach does not produce fair representation of profits– s 84 override applied – appeal dismissed.

FIRST-TIER TRIBUNAL
TAX CHAMBER

GDF Suez Teeside Limited (Formerly Teeside Power Limited) Appellant

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS Respondents

TRIBUNAL: JUDGE Rachel Short
Nigel Collard (Member)

Sitting in public at Royal Courts of Justice, the Strand London on 13 – 15 April 2015

Mr Peacock QC of 11 New Square Lincoln's Inn and Mr Boulton QC of One Essex Court Temple, instructed by Slaughter and May for the Appellant

Mr Milne QC and Ms Wilson, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. This appeal relates to taxable profits which HMRC say arise to the Appellant as a result of the transfer of loan relationships to a subsidiary company on 5 December 2006 and 2 March 2007. Specifically HMRC believe that the Appellant should bring an amount of £194,899,838 into charge to tax as a loan relationship credit for its accounting period ending 5 December 2006 and an amount of £5,154,631 for its accounting period ending 30 September 2007.

Agreed Facts

2. The Appellant, which was then known as Teesside Power Limited, ("TPL") operated, at Redcar and Cleveland, the UK's largest Combined Cycle Gas Turbine power station (Teesside Power Station) from 1993 onwards. The power station was built, owned and operated by the Appellant. The Appellant's business included selling electricity on a wholesale basis to customers such as Enron Corporation and British Energy.

The collapse of Enron

3. TPL held long-term power purchase agreements with Enron Capital Trade Resources Limited ("ECTRL") and Enrici Power Marketing Limited ("Enrici") which required ECTRL and Enrici to purchase electricity from TPL at agreed volumes and prices. ECTRL and Enrici had contracted to buy the majority of the output of the power station under "off-take" agreements. ECTRL and Enrici were part of the Enron group of companies. Enron Corporation ("EC") guaranteed the "off-take"agreements entered into by Enrici and ECTRL.

4. The Enron group collapsed into bankruptcy during the term of the purchase agreements. As a result, ECTRL and Enrici (and EC as guarantor) owed substantial amounts to TPL for failure to continue to perform under the contracts. Substantial claims were submitted by TPL against the Enron group for failing to fulfil the contracts. Claims (reflected in the amounts set out below) were subsequently agreed.

5. Following Enron's collapse, PriceWaterhouseCoopers ("PwC") were appointed administrators of ECTRL on 29 November 2001 under the Insolvency Act 1985. The Appellant was a significant creditor in the ECTRL administration. The Appellant's ECTRL claim (the "ECTRL Claim") was the subject of a settlement deed dated 27 September 2005, under which ECTRL admitted a liability to the Appellant of £360,767,273 together with accruing interest.

6. EC filed for Chapter 11 bankruptcy protection in the US on 4 December 2001. A US Bankruptcy Court Order dated 29 September 2005 allowed the Appellant's claims as general unsecured claims in the aggregate amount of $907,720,278 (which equated to £621,138,061 at the exchange rate prevailing at 31 December 2001). The Appellant was described as a Class 4 Creditor in relation to this claim. (the "Enron Claim").

7. The US Bankruptcy court approved the plan to distribute EC's assets to creditors on 15 July 2004, and the plan became effective on 17 November 2004.

8. Enrici was placed into administration in the UK on 12 January 2006 and went into creditors' voluntary liquidation on 21 December 2006. The Appellant was a creditor as to £101,071,188.

9. On 16 March 2007, the High Court sanctioned a Scheme of Arrangement allowing the administrators of ECTRL to realise and repay assets to its creditors, including the Appellant. EC and the administrators of ECTRL issued letters on 15 and 17 November 2006 respectively, recognising the extent of the Appellant's claims against them. The administrators of Enrici issued a letter on 19 February 2007 recognising the extent of the Appellant's claims. (the "Enrici Claim").

Distributions in respect of the Claims

10. In respect of the Enron Claim, the Appellant received cash distributions out of the bankruptcy estate from time to time prior to 5 December 2006, which in aggregate amounted to £120,682,000, and a distribution of shares with a value of £13,942,000. The amounts were broken down as follows:

Accounted for in period ended 31 December 2005

Received before 31 December 2005:

Cash distribution	£13,286,000
Received after 31 December 2005:	
Valuation of 808,093 Portland	
General Electric Shares	£13,942,000
Cash distribution	£60,699,000
Total	£87,927,000

Accounted for in period ended 5 December 2006

Received 1 January 2006 to 5 December 2006:

Cash distribution	£46,697,000

11. These amounts were recognised as exceptional items in the profit and loss account in TPL's financial statements for the periods ended 31 December 2005 and 5 December 2006 respectively. In both periods TPL paid corporation tax on the amounts received. The accounting and tax treatment of these amounts is not disputed.

TPL received no distributions in respect of the ECTRL and Enrici Claims during those periods.

The assignment transaction

12. On 1 December 2006, TPL established a wholly owned subsidiary, Teesside Recoveries and Investments Limited ("TRAIL"), which was incorporated and tax resident at all times in Jersey. For UK corporation tax purposes, TRAIL was a "controlled foreign company".

13. On 5 December 2006, TPL assigned to TRAIL its rights in relation to a proof of claim against EC which had been recognised by the US Bankruptcy Court. The consideration for the assignment was the issue by TRAIL to the Appellant of 101,100,347 ordinary shares of £1. (the Enron Claim)

14. Also on 5 December 2006, the Appellant assigned to TRAIL its rights under a settlement deed with ECTRL. The consideration for the assignment was the issue by TRAIL to TPL of 93,799,491 ordinary shares of £1. (the ECTRL Claim)

15. On 2 March 2007, TPL assigned to TRAIL its rights in the Enrici Claim. The consideration for the assignment was the issue by TRAIL to TPL of 5,154,631 ordinary shares of £1. (the Enrici Claim)

16. The fair value of each of the Enron, Enrici and ECTRL Claims (the "Claims") was in each case equal to the fair value of the shares in TRAIL issued in consideration for the assignment. In each of the assignment agreements the shares issued in consideration for the assignment of the Claim were referred to as the "*Consideration Shares*". Paragraph 2.3 of each assignment agreement states:

> "*The parties hereby acknowledge that the issue of the Consideration Shares by the Buyer to the Seller represents fair market value for the [Claim]*"

17. The Consideration Shares were not issued at a discount. Both before and after each issue of Consideration Shares, TPL owned 100% of the issued share capital of TRAIL.

Realisation of the Claims by TRAIL following the assignment

18. On the following dates TRAIL received the following sums in respect of the Claims:

July 2007	Distribution from ECTRL Administrator	£84,114,434
November 2007	Distribution from Enrici Liquidator	£2,547,582
April 2007-January 2008	Distribution from EC Administrator	£60,911,081
Various	Distribution from EC Administrator of Portland General	

Electric shares	£3,972,128
Various Dividends from Portland General Electric	£117,076
March 2008 Sale of ETRL Claim	£40,054,492
May 2008 Sale of EC Claim	£45,318,037
May 2008 Sale of Enrici Claim	£6,114,027
Total	£243,149,027

19. The Claims were the only assets held by TRAIL. After the Claims had been transferred to TRAIL it received a total of £243 million during the next 18 months for these Claims. The proceeds from this realisation of their value by TRAIL were lent back to TPL on an unsecured and interest free basis. On 3 July 2008 the directors and shareholders of TRAIL passed a special resolution to wind up the company.

20. HMRC issued closure notices on 1 August 2013 assessing TPL to tax in respect of profits arising represented by the value of the shares received on the transfer of the claims to TRAIL for the two disputed accounting periods; £194,899,838 for the Enron and ECTRL Claims for the 2005-6 period and £5,154,631 for the Enrici Claim for the 2006-7 period. TPL appealed against these assessments on 27 August 2013. A statutory review was undertaken in 31 October 2013 confirming HMRC's position. TPL appealed to this Tribunal on 25 November 2013.

Agreed matters.

21. The Claims are money debts and loan relationships within the loan relationship code in accordance with s 81(3) Finance Act 1996. ("FA 1996")

22. The sale of the Claims in consideration for the TRAIL shares is a related transaction for the purposes of s 84 and s103(1) FA 1996.

23. The Claims are properly to be treated as contingent assets for accounting purposes under FRS12 prior to their assignment to TRAIL and so cannot, for accounting purposes, be recognised in TPL's balance sheet.

24. The Claims had been recognised in the US bankruptcy proceedings of EC and in the UK administration process of ECTRL and Enrici.

25. The transfer of the Enron and ECTRL Claims to TRAIL was notified to HMRC on 8 December 2006 under s 308 Finance Act 2004 "Disclosure of Tax Avoidance Schemes" (DOTAS) rules because the purpose of the transaction was to take the realisation of profits under the debt claims outside the charge to corporation tax. The notification stated that the arrangement was "*to enable a UK Company to indirectly realise the value of an existing asset .... which had no carrying value under UK*

GAAP without triggering an immediate tax charge by transferring it to a foreign subsidiary in exchange for the issue of shares"

26. The valuation of the Enron and ECTRL Claims by Carval Investors LLC ("Carval") in December 2006 was an arm's length third party valuation of the then current value of the Enron and ECTRL claims.

27. The TRAIL shares were not issued at a discount.

28. Neither TRAIL's accounting nor tax treatment in respect of the shares nor the Claims are in dispute; the only dispute is the tax and accounting position in TPL.

Matters in dispute

29. There are four questions which the Tribunal is asked to consider:

(a) Was the accounting treatment adopted by TPL in respect of the transfer of the Claims permissible in accordance with UK GAAP at the material time?

(b) Would there have been available any alternative accounting treatments in respect of the transfer which would have been permissible in accordance with UK GAAP, and if so what were those treatments?

(c) If, following on from issues (a) and (b), more than one UK GAAP-compliant accounting treatment was available, was TPL required by s 84(1) FA 1996 to bring debits and credits into account for corporation tax purposes in accordance with one of those alternative accounting treatments in particular (and if so which one)

(d) If, following on from issues (a) and (b) the only UK GAAP-compliant accounting treatment available was the one adopted by TPL, was TPL required by s 84(1) FA 1996 to bring debits and credits into account for corporation tax purposes in respect of the transfer otherwise than by reference to UK GAAP compliant accounts, and if so, how are such debits and credits to be determined?

30. The Appellant says that TPL's accounting treatment, in not recognising any profit when the debt claims are transferred reflects economic and commercial reality; there was no profit at the time of the transfer.

31. HMRC argues that there was a profit made by TPL at the time of the transfer, represented by the value of the shares in TRAIL and supported by the valuation provided by Carval. The Appellant's approach results in this profit being made to disappear from the UK tax net.

Law

32. S 80 FA 1996 – this is the basic charging provision for profits and gains from loan relationships:

(1) *"For the purposes of corporation tax all profits and gains arising to a company from its loan relationships shall be chargeable to tax as income in accordance with this Chapter "*

(5) *"Subject to any express provision to the contrary, the amounts which in the case of any company are brought into account in accordance with this Chapter as respects any matter shall be the only amounts brought into account for the purposes of corporation tax as respects that matter*"

33. S 82 FA 1996 – this sets out how profits and gains are calculated for the purposes of the loan relationship code:

"(1) *For the purposes of corporation tax*

(a) *the profits and gains arising from the loan relationships of a company,*

and

(b) any deficit on a company's loan relationships

shall be computed in accordance with this section using the credits and debits given for the accounting period in question by the following provisions of this Chapter"

34. S 84(1) – The debits and credits which fairly represent profits:

"*The credits and debits to be brought into account in the case of any company in respect of its loan relationships shall be the sums which, when taken together, fairly represent for the accounting period in question –*

(a) all profits, gains and losses of the company, including those of a capital nature, which (disregarding interest and any charges or expenses) arise to the company from its loan relationships and related transactions; and

(b) *all interest under the company's loan relationships and all charges and expenses incurred by the company under or for the purposes of its loan relationships and related transactions*"

35. S85A and 85B – The debits and credits derived from this Chapter:

S 85A(1) "*Subject to the provisions of the Chapter (including, in particular, section 84(1)), the amounts to be brought into account by a company for any period for the purposes of this Chapter are those that, in accordance with generally accepted accounting practice, are recognised in determining the company's profit or loss for the period*".

S 85B(1) "*Any reference in this Chapter 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 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*".

36. S 50 Finance Act 1994 provides the definition of generally accepted accounting practice.

37. 50(1) *In the Tax Acts "generally accepted accounting practice" means –*

(a) in relation to the affairs of a company or other entity that prepares accounts in accordance with international accounting standards ("IAS Accounts") generally accepted accounting practice with respect to such accounts,

(b) *in any other case, UK generally accepted accounting practice*"

38. We were also referred to a number of case authorities:

(1) Odeon Associated Theatres Ltd v Jones [1971] 2 AER 407

(2) Stanton v Drayton Commercial Investment Co Ltd [1982] STC 585

(3) *Gallagher v Jones* [1993] STC 537

(4) *Johnston v Britannia Airways Ltd* [1994] STC 763

(5) DCC Holdings (UK) Limited v HMRC [2007] STC (SCD) 592

(6) DCC Holdings (UK) Limited v HMRC [2008] EWHC 2429

(7) *HMRC v DCC Holdings (UK) Limited* [2009] EWCA Civ 1165

(8) *DCC Holdings (UK) Limited v HMRC* [2010] UKSC 58

(9) *Versteegh v HMRC* [2013] UKFTT 642 (TC)

(10) Spritebeam & Others v HMRC and another [2015] UKUT 0075 (TCC)

(11) *Greene King Plc v HMRC* [2012] UKFTT 385(TC) & [2014] UKUT 0178 (TCC)

Evidence

Accounts of TPL and TRAIL

39. We were taken to the Directors' report and financial statements of TPL for the period 1 January 2006 to 5 December 2006. These accounts were prepared under the historical cost convention. Reference was made in the Directors' report to the

incorporation of TRAIL and its purpose to hold the Claims. The Claims were not recognised in TPL's accounts prior to their transfer to TRAIL. On 5 December 2006 the investment in TRAIL was shown at nil. Note 10 to the accounts stated that "*The investment in TRAIL is stated at the cost of £nil, being the carrying value of the claims transferred to TRAIL at the date of the transfer.* The accounts included the independent auditor's report and Ernst &Young LLP's ("E&Y") confirmation that the financial statements gave "*a true and fair view in accordance with UK GAAP of the state of the company's affairs as at 5 December 2006 and its profits for the period*".

40. We also saw the Directors' report and financial statements of TPL for the period 5 December 2006 to 30 September 2007. Those included a repeat of Note 10 concerning the investment in TRAIL but also referred to a borrowing of £132,999,000 from TRAIL in November 2007 on an interest free basis. The accounts included the independent auditor's report and E&Y's confirmation as for the previous period's accounts.

41. We were shown the Directors' report and financial statements of TRAIL for the period 1 December 2006 to 30 November 2007, which included the statement that its principal activities were "*to hold interests in claims against certain Enron entities assigned to it from its parent*". The accounts showed that £131,513,925 had been received on the sale of the Claims and referred to the loan receivable which TRAIL had from TPL in respect of an interest free loan of £133 million. TRAIL's treatment of the Claims was set out in Note 1 stating that "*The Claims receivable are stated at their recoverable value. Unrealised gains are recognised within the profit and loss account*".

Assignment Agreements

42. We saw each of the Assignment Agreements relating to the Enron, Enrici and ECTRL Claims:

(1) Assignment Agreement in respect of the Enron Claim between TPL and TRAIL of 5 December 2006 relating to the US claims taking the form of an equitable assignment of the TPL claims in exchange for 101,100,347 £1 shares.

(2) Assignment Agreement in respect of the ECTRL Claim between TPL and TRAIL taking the form of a legal assignment of 5 December 2006 with the ECTRL claims in exchange for 93,799,491 £1 shares.

(3) Assignment Agreement between TPL and TRAIL of 2 March 2007 relating to the UK Enrici Claims in the form of a legal assignment of the Enrici claims in exchange for 5,154,631 £1 shares.

(4) All the assignment agreements contained similar terms including:

(a) Clause 2 "Sale Purchase and Consideration"

"*2.1 Subject to the terms and conditions of this agreement, the Seller hereby agrees to assign [in equity] the [Enron] Claims to the Buyer with effect from Completion (the "Assignment").*

2.2 The Buyer hereby accepts the Assignment and agrees to issue to the Seller the Consideration Shares as consideration for the Assignment.

2.3 The parties hereby acknowledge that the issue of the Consideration Shares by the Buyer to the Seller represents fair market value for the [Enron] Claims"

(b) Clause 5 "Non Reliance and Independent Investigation"

5.3 "*The Seller and Buyer agree that the Seller shall have no obligation to re-purchase or re-acquire all or any part of the [Enron] Claims from the Buyer or to support any losses directly or indirectly sustained or incurred by the buyer for any reason whatsoever"*

43. We saw the letter from Enron to TPL allowing the US bankruptcy claims numbered 10784 and 10781 15 November 2006 against EC and PWC's letter to TPL of 17 November 2006 confirming the validity of TPL's UK debt claims against ECTRL.

Valuations

44. We were shown the Carval memorandum of 1 December 2006 to the directors of TRAIL setting out the current market value of the Enron and ECTRL Claims as totalling just under £194,900 million being $199,698,461 (£101,100,347), or 22 cents per dollar for the Enron Claim and £93,799,491, or 26 pence per pound for the ECTRL Claim.

45. We did not see an equivalent valuation of the Enrici Claim but were told that the valuation on assignment to TRAIL was carried out by reference to the same factors as for the ECTRL and EC Claims.

Accounting Advice

46. We saw the E&Y letter to HMRC dated 9 September 2009 setting out TPL's accounting treatment of the Claims prior to 5 December 2006, the reasons for the transfer of the Claims to TRAIL and the valuation of the Claims by TRAIL;

"*In summary although it was recognised that the claims had a positive value (and accordingly were a contingent asset for TPL), the criteria under applicable accounting rules which would have allowed the company to recognise value for its claims on its balance sheet were not met*"

47. We saw the E&Y letter to HMRC of 20 September 2011 giving their views of the accounting treatment for the transfer of the Claims and the TRAIL shares by valuing them both at cost and the alternative of fair valuing the assets ;

"It might also be possible for a company to use the fair value of the assets given as the costs of the shares acquired....... while such an accounting treatment could conceivably have been adopted by TPL, there was no requirement for it to do so"

"We consider an approach whereby an unrealised profit was recognised would have been regarded as unusual under UK GAAP"

48. We saw E&Y's letter to HMRC of 12 March 2012 giving further accounting analysis of the transfer of the Claims by TPL stating that:

"TPL did not record a gain on the transfer of the claims in TRAIL and recorded its new investment in TRAIL at the carrying value of the claims assets transferred. Just as TPL had a choice in terms of the basis on which it prepared its accounts it equally had a choice to have recorded a gain in the STRGL...... TPL did not choose that option".

49. We saw the "DOTAS" notification to HMRC referring to the assignment of the ECTRL and Enron Claims transaction dated 8 Dec 2006.

Accounting Literature

50. We were taken to extensive accounting literature including:

(1) **FRS 5 –** Substance of transactions, which states that:

"14 *A reporting entity's financial statements should report the substance of the transactions into which it has entered. In determining the substance of a transaction, all its aspects and implications should be identified and greater weight given to those more likely to have a commercial effect in practice. A group or series of transactions that achieves or is designed to achieve an overall commercial effect should be viewed as a whole."*

"51 *Whatever the substance of a transaction, it will normally have commercial logic for each of the parties to it. If a transaction appears to lack such logic from the point of view of one or more parties, this may indicate that not all related parts of the transaction have been identified or that the commercial effect of some element of the transaction has been incorrectly assessed*."

"52 *It follows that in assessing the commercial effect of a transaction, it will be important to consider the position of all parties to it, including their apparent expectations and motives for agreeing to its various terms......*

Identifying assets and liabilities

"53 *In accounting terms, the substance of a transaction is portrayed through the assets and liabilities, including contingent assets and liabilities, resulting from or altered by the transaction. A key step in reporting the substance of any transaction is therefore to identify its effect on the assets and liabilities of the entity."*

Assets – control of access to benefits

> **“**54 *The definition of an asset requires that access to future economic benefits is controlled by the entity. Access to future economic benefits will normally rest on a foundation of legal rights, although legally enforceable rights are not essential to secure access. Control is the means by which the entity ensures that the benefits accrue to itself and not to others. Control can be distinguished from management (i.e. the ability to direct the use of an item that generates the benefits) and, although the two often go together, this need not be so.”*

> *“95 An entity may directly control access to future economic benefits or may control such access through the medium of another entity, normally a subsidiary... Control through the medium of another entity (i.e. a subsidiary) is of such widespread significance that it underlies the statutory definition of subsidiary undertaking and is reflected in the requirement for the preparation of consolidated accounts”.*

(2) **FRS 12** – Provisions, Contingent Assets and Contingent Liabilities, which sets out the definition of a contingent asset:

> “*A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity’s control*”

and clarifies whether you can recognise contingent assets:

> *“ 32 Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.*
>
> *33 Contingent assets are not recognised in financial statements because it could result in the recognition of profit that may never be realised. However, when the realisation of the profit is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate”*

(3) **FRS 18** –Accounting Policies: This sets out the principles to be applied in selecting the appropriate accounting policies and includes the following

> *“Balancing Different Objectives*
>
> *43 There can also be tension between two aspects of reliability – neutrality and prudence. While neutrality involves freedom from deliberate or systematic bias, prudence is a potentially biased concept that seeks to ensure that under conditions of uncertainty gains and assets are not overstated and losses and liabilities are not understated. This tension exists only where there is uncertainty, because it is only then that prudence needs to be exercised. In the selection of accounting policies, the competing demands of neutrality and prudence are reconciled by*

finding a balance that ensures that the deliberate and systematic understatement of assets and gains and overstatement of liabilities and losses do not occur"

(4) **Urgent Issues Task Force ("UITF") 31 –** Exchanges of Businesses or other non-monetary assets for an interest in a subsidiary, joint venture or associate.

"The UITF reached a consensus that where an entity (A) exchanges a business or other non-monetary assets for an interest in another entity (B), which thereby becomes A's subsidiary or which is or thereby becomes A's joint venture or associate, the following accounting treatment should apply in A's consolidated financial statements:
(a) to the extent that A retains an ownership interest in a business or non-monetary assets exchanged for an interest in B after such a transaction, even if that business or non-monetary assets is then held through B as a subsidiary, joint venture or associate, that retained interest, including any related goodwill, should be included at its pre-transaction carrying amount.
(b) A's share of net assets acquired through its new interest in B should be accounted for at fair value, with the difference between these and the fair value of the consideration given being accounted for as goodwill."

(5) **FRS 3 –** Reporting Financial Performance.

13 "*All gains and losses recognised in the financial statements for the period should be included in the profit and loss account or statement of recognised gains and losses*" (STRGL)

21 "*The profit and loss on the disposal of an asset should be accounted for in the profit and loss of the period in which the disposal occurs as the difference between the net proceeds and the net carrying amount, whether carried at historical cost or at valuation*"

(6) **Statement of Principles For Financial Reporting –** setting out the principles which the Accounting Standards Board believes should underlie the preparation and presentation of general purpose financial statements.

Witness Evidence

51. Mr Wild gave expert evidence on behalf of TPL. He is a fellow of the ICEAW and formerly head of Deloitte's financial reporting technical department and a member of the UK Accounting Standards Board. Mr Wild provided two written expert reports to the Tribunal dated 10 December 2014 and 16 January 2015 and signed the joint experts' memorandum dated 18 March 2015. Mr Wild struck us as a knowledgeable expert witness with extensive experience of both accounting theory and practice acquired through many years of employment as a technical accounting expert.

52. Mr Wild's starting premise was clear; accounts exist primarily to provide information to shareholders, that is the overriding requirement "*to communicate in a meaningful manner that enables the user of financial statements to understand the company's state of affairs*".

53. Mr Wild's expert opinion was that the accounting treatment adopted by TPL was in accordance with UK GAAP and there was no alternative permissible accounting treatment which would have been in accordance with UK GAAP. The accounting treatment relied upon by HMRC as explained by their expert witness was not in accordance with UK GAAP.

Application of FRS 5 – The substance of the transaction.

54. FRS 5 is intended to ensure that profits cannot be over stated by ignoring the substance of a transaction. TRAIL was a wrapper only; it only held the Claims, and its existence should be ignored for accounting purposes; in substance TPL still held the Claims because it controlled TRAIL and remained exposed to the risks and rewards of the Claims, despite the fact that TPL obtained a fixed amount for those Claims in the form of the TRAIL shares.

55. Mr Wild made clear that this conclusion did not hinge on the fact that this transfer was made to a subsidiary, the same analysis would apply if a transfer was made to a third party but there was no change from the transferor's perspective in the risks and benefits of the asset transferred. A gain would only be recognised on an exchange for shares such as this if the shares brought with them some new, external value.

56. The fact that the assets under consideration here were contingent assets was also not crucial to the way in which FRS 5 was applied. Mr Wild described FRS 5 as "*working out the substance of a transaction as a result of its form*".

UITF 31 – Exchanges of Businesses.

57. Mr Wild said that in circumstances where assets have been exchanged for shares in a subsidiary there was no real gain; the Claims and the TRAIL shares have the same market value. The shares have no independent value over and above the value of the Claims. TPL is no better off as a result of the transfer to TRAIL. No third party value has been added to TPL; there has just been a re-arrangement within the group. This is supported by UITF 31, the approach of which is a suitable analogy for what has occurred in this transaction because it provides guidance about the most appropriate treatment for the exchange of non-monetary assets for shares in a subsidiary. A gain should only be recognised to the extent that you get in return some value coming from an external party. In Mr Wild's view the Claims are not monetary assets, in particular because of their contingent nature.

58. Mr Wild was of the view that HMRC's approach "drove a coach and horses" through FRS 5 and would allow companies to recognise value in contingent assets merely by putting them into a subsidiary.

FRS 12 – Contingent Assets.

59. Mr Wild explained that FRS 12 reflected the prudence principle underlying all accounting; its objective was to ensure that contingent assets should not be recognised because to do so would recognise profits which may never be realised. Contingent assets will always be valued at nil on inception. There is an absolute bar on recognising contingent assets. It was agreed that the Claims were contingent assets prior to the transfer to TRAIL. They remained contingent assets after the transfer from TPL's perspective. TRAIL is obliged to treat them as non-contingent assets because it has paid for them through the issue of shares at par and so needs to recognise a credit to offset the debit. The transfer of a contingent asset in exchange for shares turns it into an asset and its value from nil in the hands of the transferor to the price paid by the transferee, TRAIL in this case.

60. For accounting purposes an asset cannot be recognised until it moves from being a contingent to a non-contingent asset. It is not possible to re-value a contingent asset as the degree of contingency decreases because no asset exists. Assets remain contingent until payment is actually received or is virtually certain to be received. The most that TPL could have done to give information about the value of the Claims was to include this as a note to their accounts in 2006 and 2007.

61. Mr Wild did not consider that his opinion was affected by whether the TRAIL shares were a contingent asset or not. Despite the fact that the shares themselves might be treated as an asset, it was necessary to look at the future economic benefits flowing from the assets underlying the shares; and these were contingent.

62. Mr Wild said that it was standard practice for assets to be transferred on an exchange like this at cost; the claims were recognised at nil (or not recognised at all) by TPL and should be brought into TRAIL's books at cost. The carrying value of TRAIL in TPL's accounts should be added to the value of the items transferred to TRAIL; nil plus nil.

63. There was an alternative to valuing the asset transferred to the subsidiary which would be to record an unrealised gain in the STRGL as E&Y's letters suggested, but that could not be applied here because what was being transferred was a contingent asset which could not be re-valued. FRS 12 does not say or imply that contingent assets can be re-valued through STRGL.

64. Mr Wild described HMRC's approach as formalistic; forcing a credit balance in TPL's accounts because a debit for the purchase of the shares had been recognised. The profit did not disappear as HMRC suggest; the profit had never been there, because there was no accounting recognition of a contingent asset. The profit had not arisen at the time of the transfer to TRAIL.

65. Any mismatch between TPL and TRAIL arose from the different economic impact on the entities which had to be communicated to the shareholders of each entity. From TPL's perspective nothing had happened; from TRAIL's perspective there had been significant change.

Statement of Principles.

66. Mr Wild criticised Ms Baird's reliance on some paragraphs from the Statement of Principles for Financial Performance which he said were taken out of context and did not provide guidance about how to determine the transaction price and did not form particular requirements for particular accounting treatments.

FRS 3 – Reporting Financial Performance.

67. Mr Wild disagreed with Ms Baird's reliance on FRS 3 to suggest that unrealised gains need to be recognised when they exist. According to Mr Wild, in practice most unrealised gains were not recognised and in many instance their recognition was actually prohibited.

FRS 18 – Accounting Policies

68. In response to questions from Mr Milne, Mr Wild resisted the suggestion that TPL had failed properly to balance competing claims of neutrality and prudence in TPL's accounts. No gain had been omitted as a result of this approach, the gain had been moved from TPL to TRAIL. The motives of the directors for TPL entering into these transactions should not override the good communication which was the purpose of the accounts.

69. Mr Wild explained what would happen when the Claims were paid out to TRAIL. They would then be realised assets for TRAIL. From TPL's perspective it could choose whether to continue to carry the value of the TRAIL shares at historic cost, as TPL did, or revalue at that time. If the TRAIL shares were not re-valued at that time, TPL would only realise the profits from the Claims when TRAIL was wound up.

Ms Baird.

70. Ms Baird is a member of the ICAEW. She qualified in 1994 and has been employed as an accountant by HMRC since 2009. She gave expert evidence on behalf of HMRC, produced two written reports to the Tribunal dated 3 May 2014 and 16 January 2015 and signed the agreed experts' memorandum dated 18 March 2015

71. Ms Baird's view was that the accounting treatment adopted by TPL was not in accordance with UK GAAP and that there was an available alternative treatment which was in accordance with UK GAAP which should have been applied.

72. The result of the transfer of the claims was that TPL had received something of value; the shares in TRAIL. It had swapped a contingent asset for a fixed, non-contingent asset and this should be reflected in their accounts. As a result of the transfer of the Claims the value of the shares in TRAIL should be increased by the cost of the shares, that is the consideration given for them: £200 million. There is no question that the shares were properly valued at £200 million and there has to be an offsetting credit in TPL's books to reflect that acquisition.

The Application of FRS 5 – the substance of the transaction

73. Ms Baird explained that she had taken account of FRS 5 but believed that her accounting approach reflected the substance of the transaction, being the sale of the Claims to TRAIL for an agreed consideration. The substance of the transaction was reflected in the form of the contract between the parties. TPL had disposed of something which was worth £200 million in exchange for consideration of £200 million. The exchange changed the asset from being a contingent to a non-contingent asset. If the Claims had been sold to a third party there would have been a realised gain, but in this case, there was an unrealised gain.

74. Ms Baird accepted that TPL had the control over TRAIL which a parent has over its subsidiary but said that TRAIL could not be ignored as a wrapper which was not a term recognised by accounting principles in the UK (although she did accept that IFRS 12 referred to it). TPL now had only indirect exposure to the contingent assets, so was in a different position than prior to the sale. The assets of TRAIL, the Claims, are not the assets of TPL, a company does not account for all the assets of a subsidiary as if they were its own.

75. Ms Baird accepted that it was not the assignment of the Claims which created their market value.

Application of FRS 12 – Contingent Assets

76. Ms Baird said that the claims were contingent assets under FRS 12 but the shares in TRAIL were not contingent as they were fixed with an established value. The fact that the Claims were contingent assets does not mean that the shares must also be contingent assets. FRS 12 did not apply to the accounting treatment of TPL's investment in shares issued by TRAIL. TPL no longer had a contingent asset after the sale, as it was no longer exposed to the risk that it might receive less for the Claims. The sale of the Claims resulted in an unrealised gain equal to the consideration received which should have been recognised by TPL in its STRGL. By disposing of the Claims TPL had failed to recognise a profit that would otherwise have been recognised. Ms Baird resisted the suggestion that her approach led to a recognition of profits counter to FRS 12; her approach only recognised an unrealised gain.

UITF 31 – Exchanges of Businesses

77. In Ms Baird's opinion UITF 31 was not relevant to this transfer; it only applies to consolidation accounts and when there is a true exchange of assets, which this was not. It applies to the accounting treatment of a proportional interest acquired in which a business or other non-monetary asset is exchanged for an interest in a subsidiary, but this transaction entailed the sale of a monetary asset for an agreed consideration to a 100% subsidiary.

78. Ms Baird pointed out that the E&Y correspondence of March 2012 supported her approach; that the unrealised profit represented by the value of the shares in TRAIL should be recognised in TPL's STRGL and so included as a taxable credit under s 85B FA 1996.

79. Ms Baird confirmed that the only difference between her and Mr Wild was that she would recognise the £200 million gain as unrealised in STRGL at the time of the assignment while Mr Wild would recognise a gain only at the time when TPL actually received cash (through distributions in respect of, or the sale of the TRAIL shares).

80. Ms Baird agreed that there was no explicit statement in FRS 5 or 12 which set out the accounting approach which she was suggesting.

Statement of Principles

81. Ms Baird's view was that the Statement of Principles suggested that the transaction price at which this asset, the Claims should be determined, was its fair market value and that was the value of the TRAIL shares. The Statement of Principles says that "*It can generally be assumed that in the absence of evidence to the contrary, a transaction has been carried out at fair value*".

FRS 3 Reporting Financial Performance

82. Ms Baird's approach referred to the disposal of the Claims being described by TPL's directors as giving rise to unrealised gains and suggested that FRS 3 meant that unrealised gains had to be recognised in a company's STRGL if they existed. There is no option not to recognise these unrealised gains, because there is an unrealised profit as a result of the assignment to TRAIL.

Summary of accounting issues:

83. The parties provided a summary of both the points on which the expert witnesses agreed and those on which they differed in respect of TPL's accounting treatment for the Claims and the TRAIL shares. The points of agreement were not extensive, being limited to the fact that TPL should use historical cost as the basis for its accounting, that TPL should add the cost of the TRAIL shares issued in exchange for the transfer of the Claims to its existing carrying cost of the original TRAIL shares approximately £2. It was also agreed, for the purposes of FRS 12 that the Claims were contingent assets for TPL and that there was a general prohibition on recognising contingent assets to prevent the recognition of profits which may never be realised. The distinction between contingent assets being treated as having nil value or not being assets at all makes no difference to this analysis. Finally it was agreed that FRS 5 meant that TPL had to report the substance of the assignment transaction, that as a result of the assignment TPL's control of the Claims moved from being direct to indirect control and that the value of the shares issued by TRAIL and the Claims must be the same.

84. The experts did not agree on how the cost of the TRAIL shares should be determined; Mr Wild said that the carry value of the Claims (nil – since they were unrecognised) should be added to the carrying value of the existing TRAIL shares (also effectively nil). Ms Baird's position was that rather than being treated as an exchange of assets at book value, the shares issued by TRAIL should be treated as issued at a par value equal to the value of the Claims. The Claims did not have a carrying value of nil; they had no carrying value because they were contingent assets.

85. Ms Baird's view was that the price stated in the Assignment Agreements determined by an independent valuation must be treated as the sale price of the Claims which was settled by the issue of shares for an equal value. Mr Wild thought that this approach to valuation ignored the substance and economic reality of this transaction and further corroboration was required before the "agreed price" was accepted for accounting purposes by reference to FRS 5. The "agreed price" was irrelevant because TPL was accounting for the assignment transaction at cost.

86. Mr Wild considered that in applying FRS 5 it was significant that the transaction occurred between a parent and a subsidiary; TPL had to take account of its exposure to TRAIL's shares in considering the carry value of TRAIL. Ms Baird agreed that TPL should be treated as controlling TRAIL's shares, but not its assets, so that changes in the value of those assets should not be reflected in TPL's accounts.

87. Ms Baird said that when additional shares were issued to a parent by a subsidiary that increased the cost of the investment. When items of value were passed to a subsidiary that must be reflected in the accounts of the transferor by increasing the value of the subsidiary. On the contrary Mr Wild said that the value of the subsidiary should be increased only by reference to the carrying value of the asset transferred, which in this case was nil.

88. Mr Wild believed that the prudence principle underlying FRS 12 prevented TPL from recognising a gain from the Claims both before and after their transfer to TRAIL. Ms Baird said that FRS 12 did not extend to the non-recognition of shares even if the asset underlying those shares was a contingent asset. FRS 12 did not prevent the recognition of a gain on disposal of a contingent asset.

89. Ms Baird's analysis of the substance of the transaction was that an identifiable gain had been achieved because an agreed amount of consideration was given for the Claims in the form of the TRAIL shares. Since TPL accounted for its holding in TRAIL at cost, any later changes in the value of the Claims would not give rise to a change in the value of TRAIL for TPL therefore TPL was not exposed to the future changes in the value of the Claims. Mr Wild's view was that because the Claims continued to have a variable value (depending on the likelihood of recovery) the TRAIL shares also did not have a fixed value. TPL remained exposed to the increase or decrease in value of the Claims, but through the holding of the TRAIL shares. Those Claims were still under the control of TPL. Therefore TPL could not recognise any gain on the assignment of the Claims in exchange for the TRAIL shares, and by reference to UITF 31 must carry them at the pre-assignment cost. Ms Baird said that the Assignment Agreements (clause 5.3) did not require any adjustment to the consideration given for the Claims and therefore there was no ongoing exposure to their price by TPL.

90. Ms Baird and Mr Wild disagreed over the extent of the "substance" provisions of FRS 5 when applied to assets held by wholly owned subsidiaries; Ms Baird saying that there was a substantive difference between assets held directly and assets held via a subsidiary, whereas Mr Wild saw no such difference. Mr Wild's basic premise was that TPL held nothing different before than after the assignment of the Claims; only

accounts which recognised this were in compliance with UK GAAP. Ms Baird's basic approach was that the sale of the Claims for a specified amount of £200 million could not result in no gain being recognised and accounts produced on that basis did not comply with UK GAAP.

Appellant's arguments

91. On behalf of the Appellant Mr Peacock posed the relevant question for this appeal as: "*does the assignment of the Claims with a market value of £200m for shares in a wholly owned subsidiary also with a market value of £200m give rise to a profit which should be taxable*?". The Appellant's response is that there is no profit here and certainly no profit which should be liable to tax.

92. This is supported by the fact that the Claims are treated for accounting purposes as contingent assets which do not appear on the Appellant's balance sheet, or if they do appear, have a nil value.

No profit arises from the debt for share swap.

93. Mr Peacock explained that no real profit arose from this transaction. The accounting reflects the substance of the transaction and this appeal is fundamentally about the correct accounting treatment of the assignment transactions. Any s 84 FA 1996 arguments relying on a "*fair representation of profits*" over and above the profits recognised in TPL's accounts are a "long shot". It would be a surprising conclusion to tax TPL by reference to an amount which did not appear in any set of accounts prepared by them.

94. Mr Peacock argued that the transfer of the Claims was not a sale, it was not a sale for shares, it was not a sale for cash to be settled by the issue of shares; it was an assignment in return for shares in a subsidiary. The shares which were issued for this assignment were issued at par. As a result of the assignment TPL did not make a profit, it simply swapped one asset worth £200 million for another asset worth £200 million. No monetary amount was given for the asset and therefore there was no sale.

Expert evidence

95. Mr Boulton dealt with the accounting evidence on behalf of the taxpayer and suggested that Mr Wild's expertise was to be preferred over Ms Baird's. Mr Wild had much more extensive experience than Ms Baird and only his interpretation took account of the broad purpose of the relevant standards and the broad context of the transactions, giving precedence to substance over form. Mr Wild provided a number of examples of accounting for contingent assets in practice, which Ms Baird did not do.

96. Mr Wild's analysis was consistent with the E&Y accounting letters seen by the Tribunal, in line with how similar contingent assets, such as internally generated intellectual property rights are accounted for, and supported by UITF 31.

97. Mr Boulton confirmed that in his view FRS 5 was looking for the commercial substance of a transaction, which was the same as its economic substance and stressed that the accounting treatment should not, as HMRC seem to suggest, take account of the motives for undertaking a transaction, whether for anti-avoidance purposes or otherwise. There was in any event no evidence here that a particular accounting treatment had been chosen for an avoidance purpose.

98. Mr Boulton said that the accounting treatment adopted by TPL and consistent with the expert evidence of Mr Wild reflected the economic substance of the transaction; TPL was still exposed to the future economic benefits of the Claims and was no better off as a result of their transfer. TPL's accounting was in line with the general approach of FRS 12 that a profit should not be recognised if it may never be realised.

99. This was not a case in which profits had been made to disappear; they had never been recognised in the first place. The credit which HMRC identified and the basis of Ms Baird's analysis was an accounting fiction, generated by a need to offset the debit (which is the value of the share investment). Ms Baird's analysis was comparing economic to book value, not economic to economic value.

100. Ms Baird's analysis of how an uncertain asset was exchanged for shares having an agreed fixed value was not convincing. She did not fully explain how TPL's access to the Claims changed from direct to indirect as a result of this transaction. Ms Baird failed to consider the broader implications of the accounting approach which she suggested which did not properly reflect the economic substance of the transaction.

101. Even if there was a profit as a result of the share issue, it was not a realised gain and may never be realised, so any recognition would be counter to the principles of FRS 12. The realisation of a profit depended on the uncertain future receipt of monies which did not change as a result of the transfer of the Claims.

102. The difference between the accounting experts is a difference of timing; Ms Baird believes that a profit should be recognised when the claims are assigned, Mr Wild only when the claims were realised. The profit has not disappeared; it has simply not yet arisen at the time of the assignment.

103. Mr Boulton also suggested that Ms Baird was not an "independent expert" being an in-house accountant with HMRC who took on this analysis without first having formed an independent opinion.

104. Mr Boulton stressed that there was no evidence, counter to what was suggested by Mr Milne, that TPL's accounting treatment was chosen here in order to achieve tax avoidance.

Application of s 84(1): Choice of GAAP compliant accounts

105. There is no argument that if TPL's accounts are GAAP compliant HMRC cannot nevertheless chose to impose a different set of accounts on the entity; the legislation at s 84(1) applies by reference to the credits recognised in the company's

actual accounts as long as they are GAAP compliant. In Mr Peacock's view if a company has prepared a set of GAAP compliant accounts, the legislation does not permit HMRC to go beyond the figures produced in those accounts. This is made clear in authorities such as *Johnston v Britannia* and is the basic principle which underlies s 84 (1) FA 1996. It is also made clear in the more recent authorities of *Greene King* and *Versteegh*.

106. There is no statutory basis for HMRC's approach which suggests that the s 84 requirement that accounts "fairly represent" a company's profits allows HMRC to adopt an alternative set of GAAP compliant accounts. This is made clear for example in both *Versteegh* and *Greene King, Mann J: "if a company draws up its accounts in accordance with such a method, i.e. GAAP compliant, then that is the basis on which the impact of the tax is determined, even if presenting them in another proper way might have a different effect"* at para [16].

107. It would be a startling proposition to suggest that if there is a set of GAAP compliant accounts those could be overridden by HMRC. The history of the loan relationship code is that tax follows the accounts as long as they are GAAP compliant. It is not possible for HMRC to generate a profit on some statutory basis which is outside a company's GAAP compliant accounts. There is no "statutory credit" here which could form the basis of a taxable profit.

S 84(1); Fairly representing profits

108. The loan relationship code is intended to be a comprehensive code for the taxation of profits and losses from transactions for the borrowing and lending of money as explained in the explanatory notes to the 1996 Finance Bill when the legislation was introduced "*So far as possible, the rules are designed to fit in with how companies draw up computations in their statutory accounts. Whenever possible companies will be allowed to follow what is done in their accounts*" Primacy is given to the accounts of a company to determine its taxable profits, as commented on in the recent *Spritebeam* decision. It is not open to HMRC to find a taxable amount based on a statutory credit which represents an amount not found in the GAAP compliant accounts.

109. The loan relationship legislation works in three stages: (i) look at the company's GAAP accounts (ii) identify if the sums in those accounts fairly represent the items referred to by s 84(1) (a statutory concept) and (iii) use those credits to compute the entity's taxable profits. A company's taxable profits are the product of credits and debits derived from Chapter II part IV of the loan relationship code in the Finance Act 1996. Those credits and debits are the sums fairly representing all profits and gains of a company (s 84(1) FA 1996).

110. Mr Peacock accepted that some meaning needed to be given to the "fairly representing" wording in s 84 to prevent it being otiose but in his view those words could not create a profit, they could only be used to allocate existing profits between accounting periods or to deal with a situation in which accounting profits had to be allocated partly to the loan relationship code and partly elsewhere. The provision was

about allocation and apportionment, not about creating profits. This is supported by the redrafting of s 84(1) from 2005 and the amendments proposed by the Finance Bill 2015 which are described as removing "*the requirement that credits and debits brought into account should fairly represent profits and gains arising from loan relationships. It provides a new rule for apportionment of amounts where an accounting period of a company does not coincide with a period of account*"

111. TPL cannot be taxed by reference to a credit which is not found in its GAAP compliant accounts. S 84 does not permit the creation of a free standing credit, particularly in a situation where a company has transferred an asset to a wholly owned subsidiary in return for the issue of shares of equivalent value. There is no profit or gain which credits brought into account for the purposes of s 84 could "fairly represent".

112. The *DCC Holdings* authority referred to by HMRC was not authority for creating profits beyond those produced by an authorised accounting method; as made clear by Rimer LJ in the Court of Appeal in that case. "*whatever the emphasised words may permit or require with regard to the sums arrived at in accordance with the mandatory authorised accounting method, they cannot in my view permit a substitution for any of such sums of other sums arrived at by a different unauthorised method"*.para [85]. Any statutory injunction to override accounting profits is specific to the code which applies to the sale and repurchase of securities and is not derived from s 84(1) as a standalone provision. There is no free standing "fairness" rule in s 84(1); the only yardstick of fairness is a company's GAAP compliant accounts. This is supported by the proposed removal of the "fairly represent" wording from the current equivalent of s 84(1) by the 2015 Finance Bill.

113. There is no statutory basis for HMRC to depart from a company's GAAP accounts. If this had been the intended effect of s 84(1) further guidance should have been provided in the legislation to make clear when that override should apply and clarify on what basis that amount should be determined. The only alternative would be to rely on accepted principals of commercial accounting (as referred to in cases such as *Gallagher v Jones*), but that would not help HMRC's case since those principles would produce no more profit for TPL.

HMRC's arguments

114. On behalf of HMRC Mr Milne said that the Claims were sold for an established, market value. Market and sale prices were the same. The assignment transaction was a "sale" for these purposes. The difference between a sale and an assignment on which the taxpayer relies is a distinction without a difference. The Carval valuation was a proper valuation and represented the market value at which TRAIL was entitled to issue shares.

Profits arise from the transaction

115. Mr Milne pointed out that if these profits are not realised £200 million will drop out of account for tax purposes. The profits disappear. TRAIL received a value of

£234 million for the Claims, it had a cost of £200 million in its accounts and made a profit of £43 million. TPL made no profit at all on the basis of the taxpayer's analysis unless and until TRAIL distributed its profits or TPL disposed of the TRAIL shares.

Expert evidence

116. The Appellant's accounts are not GAAP compliant. HMRC's alternative accounting method is GAAP compliant. The correct accounting would reflect the agreed value of the share consideration and recognise those unrealised gains in the STRGL. S 85A(2) would bring those amounts into account as taxable profits.

117. HMRC's proposed alternative accounting approach should be preferred even if the Appellant's accounts are GAAP compliant because only their accounts bring sums into account which fairly represent the fact of the sale of the Claims.

S 84(1) Alternative GAAP compliant accounts

118. If the Appellant's accounts are GAAP compliant, in circumstances where the accounts have produced a mismatch as a result of a DOTAS tax avoidance scheme, the alternative GAAP compliant accounts should be relied on.

119. This was a DOTAS registered avoidance scheme. FRS 18 needs to be considered in that context; this is a deliberate understatement of assets and gains.

120. Mr Milne referred to E&Y's letter of 20 September 2011 which made it clear that they accepted that HMRC's proposed accounting treatment of including unrecognised gains in STRGL on the disposal of the Claims was an acceptable accounting method.

121. According to HMRC's expert accounting evidence, there was a disposal of the Claims for consideration equal to the value of the shares issued of £200,054,469. The carry value of the TRAIL shares held by TPL should therefore be increased by the cost of the shares, £200 million.

s 84(1) Fair representation of profits.

122. Mr Milne accepted that the taxpayer's argument about how s 84 should be applied was a "long stop argument"; The relevant version of s 84 operated a two stage process, with an additional or over-arching test of whether the accounts have produced a fair view of the profits generated. It is correct that the legislation starts with the company's GAAP accounts, but there is a further stage which entails checking that the sums derived fairly represent the company's profits. The need to qualify accounts for tax purposes has been accepted in cases such as *R&C Commissioners v William Grant & Sons Distillers Ltd.* [2007] STC 680.

123. To establish taxable credits and debits under s 84(1) the company first has to bring into account amounts recognised in its GAAP compliant accounts. (s 85A and 85B). Then it has to check that these amounts are "sums which fairly represent" the company's profits and losses. Sections 85A and B are made expressly subject to s 84.

This is an understandable "long stop" to ensure that profits arising from loan relationships do not fall out of tax merely because they are not reflected in the company's accounts given that the loan relationship code is an exclusive one.

124. This is in line with the approach taken in the *DCC Holdings* case particularly by Rix and Moses LJJ in the Court of Appeal which is supported by the relevant version of s 84(1) to which s 85A and 85B are expressly subject. This means that if there are two GAAP compliant methods and one produces a tax mismatch, the override in s 84 is likely to apply. Similarly even if there is only one GAAP compliant method but a transaction has been structured to exploit that and generate a tax advantage, that is persuasive evidence that the accounting treatment does not fairly represent the company's taxable profits.

125. This interpretation is supported by the explanatory notes to the Finance Bill 2006 which inserted the words "*in particular in section 84(1)*" into s 85A, making the ability to override the accounting treatment explicit. Although it is correct that current changes to s 84 (proposed by the Finance Bill 2015) will take STRGL out of the loan relationships rules, this will be replaced by a general anti-avoidance rule which will pick up profits like these. Mr Milne referred to both the *Spritebeam* and *Versteegh* decisions and pointed out that these were decided on the old version of s 84 which did not contain the override.

126. Mr Milne relied on the approach of the Tribunal in the *DCC Holdings* case that the concept of "fair representation" in s 84(1) involved applying judgment and common sense to determine a company's profits. This is supported by the new version of s 84. Similarly Norris J in the High Court *DCC Holdings* decision said that there was no assumption in the legislation that primacy should be given to the accounting treatment. Mr Milne also referred to the statements of Rix LJ and Walker LJ in the *DCC Holdings* case in the Court of Appeal and Supreme Court respectively in support of this approach. The *DCC Holdings* case made clear that the override in s 84 was more than just an allocation or timing provision, but a general override. (Moses J in the Court of Appeal).

127. If it is correct, as the Appellant suggests, that s 84(1) applies when only part of the accounting profits fairly represent the company's profits for a particular period, then it should also apply in circumstances where none of the accounting profits fairly represent the company's gains and losses. In the admittedly exceptional circumstances in which the GAAP compliant accounts fail to represent the taxpayer's profits and losses, s 84(1) cannot just drop out of the picture, it must operate to require the sums which do fairly represent the taxpayer's profits to be brought into account. The *Greene King* decision established that it was possible for HMRC to demonstrate that accounts produced by a taxpayer were not GAAP compliant.

128. Mr Milne also relied on the *Stanton v Drayton* decision to support his conclusion that the value of the shares issued should be taken to be the consideration for tax purposes representing a sum "*honestly reached by a bargain made at arm's length*". There should on that basis be no disparity between the consideration given by the buyer and received by the seller.

129. It was clear in Mr Milne's view that the accounting treatment which had been applied here had been applied in order to enable this particular scheme to be undertaken.

Facts Found

130. The transfer of the Claims was part of a DOTAS registered scheme. The DOTAS documentation stated that the aim was to transfer the claims to TRAIL and obtain a stepped up base cost for the Claims in that entity to offset against the profits made on realisation of the Claims.

131. The valuation of the Enron and ECTRL Claims in December 2006 by Carval was a valuation by reference to external market data about Enron claim recovery, which proved to be an under-valuation. The Carval valuation took account of the likelihood of recovery of the Claims by pricing the EC claims at 22% of face value and the ECTRL claims at 26% of face value. The Enrici Claims were valued in the same way at 5% of face value. Those valuations were the basis for the consideration given in the form of TRAIL shares on the assignment of the Claims.

132. The contingent asset to which FRS 12 applied was the full amount of the outstanding claims (£1 billion with the £130 million received pre-transfer). The December 2006 valuation by Carval and the March valuation of the Enrici Claim represented the then market value of the Claims, being the estimated realisable element of that contingent asset.

133. There was an unrealised gain in the Claims. This was not recognised for accounting purposes at the time when the Claims were transferred.

Decision.

Issue 1.

Are TPL's accounts GAAP compliant accounts?

134. Our answer to this question is that TPL's accounts are GAAP compliant. Our view is that the Tribunal should be slow to upset accounts which have been given audit sign off as GAAP compliant accounts. We have concluded that Mr Wild's expert evidence to the Tribunal should be accepted and that the relevant accounting principles have been correctly applied by TPL to produce a GAAP compliant set of accounts for the disputed accounting periods.

135. Both experts' accounting approaches gave rise to odd results and had different ways of squaring the circle arising as a result of contingent assets being transferred to a subsidiary before their value had been realised; Ms Baird forced a credit to TPL on the acquisition of the TRAIL shares to make the books balance; Mr Wild forced a credit in the books of TRAIL to balance the issue of the shares to TPL "*having purchased the claims, in order to get the accounts to balance, TRAIL has to show an asset*". Mr Wild accepted that despite this accounting entry, the fact of the issue of the shares had not made the Claims any less contingent for TRAIL than they were for

TPL, but we accept his analysis that in accordance with FRS 12 contingent assets have a nil value at inception and should not be re-valued until they are realised in the form of cash, including by reflecting an unrealised gain in STRGL.

136. We have also accepted that Mr Wild's approach is in line with the substance requirements of FRS 5 and the prudence concept underlying FRS12. In particular we agree that FRS 5 does allow the accounting to ignore the intervention of a 100% subsidiary and take account of the fact the TPL remained exposed, if only indirectly to the value of the Claims. (paragraph 95 of FRS 5). This is to be preferred to Ms Baird's analysis which treats TPL as no longer exposed to the changes in value of the Claims after transfer despite the fact that they are held by a 100% subsidiary and the "fixed amount" received by TPL in exchange for the Claims is shares in that subsidiary.

137. We also accept that it is a valid starting point for the valuation of the claims to take their book value at inception and add to that their book value on transfer (by reference to FRS 12 and UITF 31). We had some doubts about the precise relevance of UITF 31 to this transaction to which we do not think it is precisely analogous but nor were we convinced by Ms Baird's alternative interpretation. Ms Baird's suggestion that the TRAIL shares be valued at fair market value (the value of the Claims) was based on the high level general principles of the Statement of Principles rather than on any more detailed analysis of the form of this particular transaction.

138. We agree with Mr Peacock and Mr Boulton that Ms Baird's analysis was not very clearly rooted in any specific principles including the principles of FRS 5 and that she could not establish a clear specification in FRS 12 or elsewhere for her approach to recognising an unrealised gain in STRGL at the time of the assignment of the Claims.

139. Mr Milne referred to FRS 18 and the requirement to balance prudence with neutrality, suggesting that this should have been applied to ensure that profits were not understated as he was suggesting had been done here. We have found it difficult to fault Mr Wild's logic in responding that for accounting purposes there were no profits to understate; at the time of the assignment of the Claims there was nothing for TPL to recognise in the terms of FRS 5 and FRS 12.

Issue 2 & 3

140. We also need to consider issues 2&3, which we think are best considered together; whether despite our conclusion above, there is an alternative set of GAAP compliant accounts as suggested by HMRC. On the basis of Ms Baird's evidence we do not believe HMRC have made a convincing case. In particular; Ms Baird's approach did not sufficiently answer the FRS 5 requirement for the recognition of the substance of a transaction and did seem to be forcing a credit into TPL's STRGL where none would naturally appear on the transfer of the Claims. This is reflected by E&Y's view in their audit letter that this was that this was an "unusual" approach. Nor did Ms Baird satisfactorily explain why the Claims should not be transferred to TRAIL at their nil (or non-existent) book cost.

141. In any event, we do not accept HMRC's interpretation of s 84 and s 85 which suggests that even if there are two GAAP compliant sets of accounts, in circumstances in which one is being utilised to support a tax avoidance scheme, it is legitimate to rely on the alternative GAAP compliant accounts. This point was made clear in the *Greene King* decision. Mann J at para [16]:

> "*If a company draws up its accounts in accordance with such a method, then that is the basis on which the impact of the tax is determined even if presenting them in another proper way might have a different effect*"

142. On this point we agree with taxpayer that if the Appellant's accounts are GAAP compliant, they have to be accepted. It does not follow, as HMRC's argument suggests, that if GAAP compliant accounts result in a sum disappearing as part of a tax avoidance scheme it necessarily means that the accounts are not GAAP compliant or in some other way inferior.

143. While we have not given great weight to this point and have concentrated on the technical arguments made by both expert witnesses, we have taken account of their relative expertise and, in particular, Mr Wild's very extensive practical experience of how these accounting standards are applied. We have not however accepted the taxpayer's suggestions that Ms Baird could not be treated as an independent witness. It was clear to us that she took and understood her obligations to the Tribunal seriously and had given her unbiased view of how the transactions should be treated for accounting purposes.

Issue 4.

Do TPL's accounts represent a fair view of profits?

144. At its heart, despite the extensive citation of technical accounting literature to us, our view is that this is an appeal less about the technical application of accounting principles and more about how far accounting principles can be taken as the basis of a taxing statute and in particular whether they can be taken so far as to result in potential profits being taken outside the UK tax net altogether.

145. In terms of the statutory approach, that question is whether or not there is implicit or explicit in s 84 a concept of "fairness" by reference to taxable profits which can override a set of accounts which are in accordance with UK GAAP and which produce a "true and fair" accounting view of a company's profits.

146. It is not in dispute that at the relevant time s 84 included a two stage process, which implies some recognition that accounting profits might not reflect a fair view of a company's profits. Counter to what was said by Mr Peacock, there is nothing on the face of legislation to suggest that this fairness is referable only to the allocation or attribution of profits.

147. Mr Peacock's approach produced a hermetically sealed version of s 84 into which only accounting profits were allowed. We view this as too restricted an approach even to legislation which takes as its starting point the accounting profits of

a company. That does not mean it is not proper to keep in mind the broader framework of the commercial impact of what has been achieved as was made clear in the *Greene King* decision and also in *DCC Holdings,* particularly in the context of a tax planning scheme such as this. The *Greene King* decision considered a different iteration of s 84(1) and concluded that the accounting treatment proposed by the taxpayer (in reliance on FRS 5) was not an acceptable accounting treatment. In coming to that conclusion Mann J relied on identifying the commercial substance of the transaction "*One asset had been disposed of (in part) and another acquired with that part. This was not window dressing. It was a matter of substance*". para [64].

148. While the loan relationship code relies on a company's accounts as a way of ascertaining profits, the accounting definition of profit is not objective and is itself open to interpretation as we have seen. It is an alternative means of coming to a measure of profit, but it is not absolute. The legislation we are concerned with is taxing legislation; the purpose of the loan relationship code is not the purpose which Mr Wild stressed was the critical principle underlying both FRS 5 and FRS 12; that shareholders should not have an inflated view of a company's profits, but that on an entity by entity, period by period basis, tax should be paid on amounts which fairly represent that entity's profits.

FRS 12 – S 84 and timing issues.

149. Mr Peacock accepted that one role of the fair representation rule in s 84(1) was to properly allocate profits on a timing basis to the correct period. That is also what FRS12 is prescribing with its insistence on the non-recognition of profits which have not and may never be realised. Mr Wild told us that FRS 12 applied in this case so that TPL was not recognising a profit at the time when the Claims were transferred because at that time they are not sufficiently certain. What he did not say, and could not say, was that there was no prospect of the claims ever being realised; there clearly was, because Carval were able to put a value on the ECTRL and Enron Claims in 2006 which was based on a view of their likely realisation. FRS 12 prohibited the recognition of the claims either before or after their assignment not because there was no unrealised profit, but only because the prospect of realisation was too distant to be recognised. This is based on the accounting concept of prudence which will always tend to defer the recognition of profits.

150. Mr Wild saw the world through a wholly accounting perspective, he said; "*I don't know anything about tax. I don't think tax should have any effect on good accounting*". We do not agree that this is a sufficient view of the world when that world has in view a transaction which has been structured to ensure that profits are deferred for tax purposes by relying on accounting rules. S 84(1) provides for an override of the credits and debits produced by an acceptable accounting method if that method has failed to fairly represent profits. Mr Wild was concerned that applying FRS 5 in the manner suggested by Ms Baird gave carte blanche to companies to inflate profits by transferring assets with unrealised value to subsidiaries and trigger a recognised profit. That might well be true for accounting purposes. However the converse is true for tax purposes; Mr Wild's approach allows companies to transfer assets with unrealised value to subsidiaries and avoid triggering a taxable profit. The

analogous tax transaction to the transfer of intellectual property rights with an uncertain value between group companies referred to by Mr Wild, is the transfer of assets pregnant with gain between members of a group of companies one of which is outside the UK tax net before the gain is realised.

151. Our view is that on any realistic commercial approach to this transaction, these Claims were monetised when they were exchanged for shares in TRAIL. We do not accept the Appellant's distinctions between an exchange and a sale for these purposes; TPL no longer directly owned the assets and had received something else in exchange. That might not be a sale, but it is a disposal for good consideration, to which the principles in *Stanton v Drayton* should apply.

152. We know that there was value in the Claims in December 2006 and March 2007 and that valuation took account of the likelihood of payment; it priced in the contingency of receipt. The valuation given to the Enron and ECTRL Claims by Carval was their non-contingent value and represented the current realisable value of those claims. We were told that the Enrici Claim had been valued in the same way.

153. Following this logic we have concluded that £200 million of profit should be recognised in TPL for the accounting periods when the Claims were transferred to TRAIL despite the fact that no profit was recognised for accounting purposes. This analysis leads to profits being recognised earlier than they would have been had the assignment of the Claims not occurred reflecting Mr Peacock's suggestion that s 84(1) could be used to properly allocate profits between accounting periods. It was accepted by Mr Wild that gains would be recognised by TPL when payments were made in respect of the Claims, through the revaluation of the TRAIL shares, when TRAIL distributed its profits or when TPL disposed of the TRAIL shares.

154. Mr Peacock suggested that it was not possible to generate a credit which was not derived from the company's accounting profits but our view is that s 85A(1) with its explicit reference back to s 84(1) must mean that this is possible at least as far as accelerating credits which would otherwise be recognised in a later accounting period. To take any other approach would remove the ability of s 84(1) to adjust credits and debits to give a fair representation of profits.

155. Nor do we think that it is correct, as the Appellant suggested, that moving away from GAAP accounts leaves the Tribunal without the ability to quantify profits. Prior to the legislative move towards the primacy of accounting profits as a basis for tax the courts were perfectly capable of identifying a profit and particularly the time at which a profit should be treated as arising for tax purposes. In this case we do not have to look far to find the correct non-contingent valuation of the Claims, it is stated in the Carval approach to valuation which was accepted by the parties.

FRS 5 – s 84 and substance issues.

156. In fact we think it is possible to go further than utilising Mr Peacock's accepted allocation only approach to the fairness override in s 84(1) and look at the wider picture, and the full scope of the transactions. As was made clear in *DCC Holdings*, it

is legitimate in determining whether a fair representation of profits has been achieved to look at all circumstances of the case; See for example Rix LJ at para [108] of the Court of Appeal decision.

157. Mr Wild stressed, correctly, that FRS 5 entailed ascertaining the substance of a transaction in order to ensure that it was properly accounted for. In his view, and again we have agreed that this is a proper application of the principles of FRS 5, this meant looking at the economic substance of the transaction; viewed from that perspective TRL had merely "wrapped" assets which it previously held directly into its 100% subsidiary. In economic terms, nothing had changed and therefore no profit should be recognised.

158. In its reliance on ascertaining the substance of a transaction, FRS 5 contains a strong subjective element, as made clear by the very different view of the substance of the transaction taken by Ms Baird and Mr Wild. It is also worth stressing that FRS 5 is an accounting principle and guide, rather than legislation. On its terms FRS 5 is a powerful tool for re-characterisation, in this instance allowing Mr Wild to conclude that assets with future value could be transferred between related companies with no current or future profit recognition. As Mr Wild made clear, FRS 5 was introduced itself as an accounting anti-avoidance measure.

159. On the contrary, tax tends not to look at the economic characterisation of a transaction and will usually respect the legal form of entities and impose tax on an entity by entity basis even in group situations. This reflects to an extent Ms Baird's resistance to Mr Wild's application of FRS 5 to TPL's shareholding in TRAIL which, she pointed out, led to TPL's accounts (and profits) including assets of its subsidiary and ignored the fact that TRAIL was a separate legal entity. While accepting Mr Wild's application of FRS 5 in this instance we have concerns about allowing the application of a subjective accounting principle to be relied on in the context of a DOTAS reported transaction. We are not convinced that FRS 5's perspective of substance, looking at economic substance over and above commercial and legal form should be allowed to predominate for tax purposes in this kind of transaction and have taken account of comments from recent authorities including in particular the *Greene King* decision, where it was said by Mann J that

> "*It is true that the economic effect of the transaction, at one level, is to leave PLC in the same position because the decrease in the value of the loan might be said to be reflected by an increase in the value of the shareholding in its subsidiary. However, in relation to the loan, the real substance of the transaction was that the loan had become less valuable*" Mann J at para [64].

And also that it was necessary to take a commercial view of the transactions which had actually occurred "*Look at the transaction which occurred in this case and determine whether it generated the profits alleged*". Mann J at para [92].

160. Mr Boulton said that the economic substance to which FRS 5 attached was the same as the commercial substance of this transaction, we do not agree that this is necessarily correct in the context of a transaction of this kind where FRS 5 has led to a re-characterisation which ignores the separate legal identity of companies.

161. With that as our starting point we have concluded that in this instance the UK GAAP compliant accounts of TPL do not give a fair representation of the profits arising to TPL from this transaction and in particular that the economic substance approach of FRS 5 should not override the requirement of s 84(1) that the profits from this transaction, the assignment of the Claims for their non-contingent £200 million value, for this entity, TPL, not the wider group, should be fairly represented. Our view is that TPL's profits for tax purposes should treat the non-contingent valuation of the shares received by it on the assignment of each of the Claims as profit arising on the transfer of the Claims in order to give a fair representation of TPL's profits for the two relevant accounting periods.

162. It might be said that this approach not only results in putting the tax treatment of profits arising from the lending of money back to where they were before the loan relationship code was introduced, removing the certainty that reliance on a company's accounts as the best measure of profits was supposed to provide, but is also counter to the approach of authorities referred to us by Mr Peacock which stressed that the courts should be slow to ignore accounting profits generated by the principles of commercial accounting:

> "*The court is slow to accept that accounts prepared in accordance with accepted principles of commercial accounting are not adequate for tax purposes as a true statement of the taxpayer's profits for the relevant period. In particular it is slow to find that there is a judge made rule of law which prevents accounts prepared in accordance with ordinary principles of commercial accounting from complying with the requirements of the tax legislation" (Johnston v Britannia Airways* Knox J at p 782 [g]*)*

Our response to that is that in the normal case the accounting measure of profits will give a fair view of a company's taxable profits. This is not the normal case; this is a structured transaction in which accounting rules have been used in order to both defer and potentially remove profits from the UK tax net. The authorities which we were referred to by Mr Peacock which stress the primacy of profits generated by principles of commercial accounting do contain caveats that the profits generated must not be "*inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business*" (*Gallagher v Jones, Bingham MR at pg 556* [*a*]). Mr Milne also referred us to the *William Grant* decision which was concerned with the application of s 42 Finance Act 1998, which introduced for trading profits an approach similar to the one which had already been introduced in 1996 for loan relationships, that taxable profits should be computed on an accounting basis giving a true and fair view of profits. In considering the requirements of s 42 Hoffman J described it as a legal test with an accounting guide "*although the requirement that the initial computation shall give a true and fair view involves the application of a legal standard, the courts are guided as to its content by the expert opinion of accountants as to what the best current accounting practice requires."* para[2].

163. Our view is that in ignoring the legal form of the transaction and treating the assets of TRAIL as the assets of its parent entity, the profits (or lack of profits) generated by the accounting approach of TPL is "inapt to determine the profits or

losses" of TPL's business and ignores the legal standard which is part of the test in s 84(1) as it is in s 42 of the Finance Act 1998. If we have to cite a "judge made rule of law" to support this it is that the tax code respects the legal form of companies and does not tax groups on a consolidated basis without a specific statutory basis to do so.

164. It might also be said that in essence we have used s 84(1) as an anti-avoidance rule to stop accounting principles being used as a way of taking profits out of the tax net and we note, as pointed out by Mr Milne, that this is in line with the proposed Finance Bill 2015 changes to the loan relationship code.

165. For all of these reasons this appeal is dismissed.

166. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

RACHEL SHORT
TRIBUNAL JUDGE

RELEASE DATE: 11 AUGUST 2015