[2014] UKUT 0178 (TCC)

Appeal number FTC/72/2012

Corporation tax – loan relationship – assignment of right to interest under the loan to another group company – effect of assignment on recognition of loan in accounts of assignor company – proper application of loan relationship provisions to the assignee company

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

(1) GREENE KING PLC
(2) GREENE KING ACQUISITIONS LTD **Appellants**

- and -

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

TRIBUNAL: MR JUSTICE MANN

Sitting in public at The Rolls Building, 7 Rolls Buildings, Fetter Lane, London EC4A 1NS on 27th, 28th & 29th November, 2nd December 2013 and 10th & 12th March 2014

Mr John Gardiner QC and Mr Michael Ripley (instructed by Reynolds Porter Chamberlain Solicitors) for the Appellants

Mr David Milne QC and Mr Richard Vallat (instructed by the General Counsel and Solicitor to HM Revenue and Customs) for the Respondents

DECISION

Introduction

1. This is an appeal from a decision of the First-Tier Tribunal (Tax Chamber) (Judges Colin Bishopp and Alison McKenna) released on 14th January 2012 [2012] UKFTT 385 (TC) in which the FTT dismissed the appeals of Greene King plc ("PLC") and Greene King Acquisitions Ltd ("GKA") against two notices of amendment relating to the corporation tax returns of those companies for the periods ended 30th April 2003 and 30th April 2004. The amendments related to two transactions undertaken by those two companies (the former being the holding company of the latter) and a third group company (Greene King Brewing and Retailing Ltd - "GKBR"), one in each of those two tax periods. The result of the amendments was to increase the tax charge in respect of those transactions. While each of the transactions was a discrete transaction, the substance and mechanics of each was the same and it is common ground that a decision in these tax proceedings on the one has exactly the same effect in law on the other, so that this appeal, like the decision below, can be determined by looking at just the first of those two transactions. I shall therefore do that. The appeal turns on the application of the regime for taxing "loan relationships" of companies. I am told that the fiscal fate of a number of other transactions (perhaps 9 or 10) turns on the same point, probably because the transactions seem to have been entered into pursuant to a marketed scheme of Ernst & Young ("EY"). The taxpayers were represented by Mr John Gardiner QC and Mr Michael Ripley; Mr David Milne QC and Mr Richard Vallat represented HMRC. The appeal was argued for the equivalent of 3 days, but the parties were recalled for further argument lasting for over half a day some time later when it appeared to me that two points required clarification.

The first transaction and the two parties' claims as to taxation consequences

2. For the reasons given above I shall set out only the detail of the first transaction, which I take from the summary included in the decision under appeal (which was itself largely derived from the parties' agreed statement of facts). I shall use round numbers for these purposes which I will continue to use for the rest of this decision. If further details are required they can be gleaned from the FTT decision.

3. The main elements were:

   (i) PLC had lent GKBR £300m on which interest was accruing. Interest was payable periodically, and the principal was repayable in May 2004.
   (ii) On 31st January 2003 PLC assigned to GKA the right to receive the remainder of the interest under the loan but retained the principal. The amount of interest remaining due at this point was £21.3m, with a net present value ("NPV") of £20.5m.

(iii) In consideration for that GKA issued £1.5m of preference shares to PLC carrying a special, and thereafter an annual, dividend. The former dividend amounted to £975,000.
(iv) The interest payments were duly thereafter made to GKA.
(v) PLC continued to recognise the whole of the £300m of the debt in its accounts.
(vi) GKA recorded the right to receive interest as a receivable at its NPV (£20.5m), credited the nominal value of the preference shares (£1.5m) as a non-equity capital instrument, and credited the difference between the £1.5 and the NPV (£19m) to its share premium account.

4. The parties' respective contentions as to the tax consequences (so far as material to this appeal) are, in outline and in round terms, as follows.

Greene King contends:

(i) PLC is no longer taxable in respect of the interest or any sum representing the same. It has divested itself of its right to receive interest. It was, however, taxable on the special dividend received in the sum of £975,000.

(ii) GKBR is entitled to treat the interest payable as a deductible in its accounts (£21.3m). (There is no dispute as to this.)

(iii) GKA is taxable on the sum of £768,000 odd, being the difference between the net present value of the income stream on assignment (the £20.5m) and the amount actually received (£21.3m), being £768,000.

Thus a large part of what would otherwise have been brought into profits in the hands of PLC for the purposes of a charge to tax (the £21.3m of interest) has escaped tax.

5. HMRC contends as its primary case:

i) PLC should de-recognise part of the value of the loans in its accounts to reflect the fact that it has become a sum in the future without a right to interest. The amount is roughly £20.5m. This gets accreted back over the period to the end of the interest payment period, so PLC is charged to tax on that sum as a profit or gain.

ii) GKBR is entitled to deduct the actual interest paid (£21.3m) by it to GKA.

iii) GKA is liable to tax for the whole of the sums received by it from GKBR (£21.3m).

6. HMRC's contention in broad terms is the effect of the decision of the FTT. If it makes it look as if there is somehow a charge to two lots of tax on the same amount then the

Revenue says it is a consequence of the artificial transaction in which the Greene King group indulged.

7. HMRC's secondary case is that:

(i) PLC is liable to tax on the £20.5m as under its primary case.
(ii) GKBR can deduct the £21.3m as the payer of interest (as above).
(iii) GKA is liable for £94,000, being the amount by which the sum written to share premium account exceeds the "minimum premium value" (MPV) prescribed by the legislation; and it is liable for tax on the £768,000 excess in value of the actual receipts of interest over the net present value of the income stream at the date of assignment (as in PLC's case).

8. HMRC also has a tertiary case which is as its secondary case, save that GKA is liable for tax on £19m odd in place of the £94,000, being the figure which arises if the MPV is nil.

9. These differences arise because of disputes as to the correct accounting treatment, and correct legal treatment, of the various interests which arise in relation to the arrangements. The two Greene King companies submitted returns claiming that the tax effect was as it is set out in a summary of its case above. The Revenue issued notices of amendment, and those notices were appealed to the FTT, which decided (in broad terms) in favour of HMRC's analysis in its primary case. PLC and GKA appealed to this Tribunal.

The broad issues

10. The issues in this case arise out of the concept of a "loan relationship" used by the Finance Act 1996 in relation to companies and corporation tax. If such a relationship exists then all profits, losses and gains arising out of that relationship are dealt with under a self-contained regime. In the case of non-trading receipts (which applies to PLC and GKA on the facts of this case) one arrives at an aggregate of credits and debits which, as an aggregate, is then treated as part of the profits or losses of the company. In the case of trading receipts (which is the case with GKBR) the credits and debits seem to be treated separately and then fed into the calculation. In order not to clutter up the body of this Decision with references to the legislation, and so that it is more readily available for cross-referencing, the relevant provisions are set out in the Appendix to this Decision, though I shall repeat some of them in the body of this Decision in order to aid the narrative. Also set out there are two provisions of the Companies Act 1985 (being the relevant Companies Act in force at the time of the transactions in question).

11. The overall issues in this case turn on the following broad points:

(i) What is the correct accounting treatment in the books of PLC arising out of the assignment of the interest stream, separately from the principal of the loan, especially bearing in mind the fact that the assignment was to a wholly owned subsidiary? HMRC maintains that the correct accounting treatment is to "derecognise" the amount of the loan standing in the books of PLC in the amount of the net present value of that stream and then to accrete that derecognised sum back to its full value over the period of the income payment and take that increase to profit and loss account. Thus (in round terms) the £300m of the loan value standing in the balance sheet before the transaction should be derecognised in the sum of £20.5m, but over the next 15 months (the remaining period of the loan, during which interest was payable) there would be accretions which would take it back up to £300m, and the £20.5m would be brought into the tax computation as a profit or gain (see HMRC's primary case). This is said to be required by the applicable accounting standards (GAAP) and the Financial Reporting Standards (FRS) applicable to the group and to this situation. PLC disputes that that treatment is required on the facts of this case.

(ii) Was there a loan relationship between GKA and GKBR? HMRC says not, or at least not a material one, with the result (as it would say) that payments received from GKA were not brought into the loan relationship provisions; or if there was such a relationship the payments were still not within it. If HMRC is right then the diverted interest payments still fall to be treated as chargeable income (or so it maintains).

(iii) If the sums or value receivable or received by GKA are otherwise liable to be taken into account in calculating gains and profits as part of a loan relationship, are they nonetheless removed from the calculation by Finance Act 1996 section 84(2)(a), which takes out of the calculation sums credited to a company's share premium account? In the present case GKA took roughly £19.5m into its share premium account (the difference between the value received and the nominal value of the preference shares issued).

These issues are broadly those addressed by the FTT, though differently phrased, and elaborated a little by me.

The statutory regime and its relevance to the present case

12. I have set out the statutory provisions of the 1996 Act in the Appendix to this judgment. For the purposes of this appeal the important points emerging from it are as follows. In

this section of the Decision I set out the structure and certain key concepts. I shall have to return to some further statutory detail when I consider the more detailed aspects of this appeal. In what follows I emphasise some of the wording and concepts which lie at the heart of this appeal.

i) The key concept is a "loan relationship". This is defined in section 81(1) as existing:

> "wherever -
>
> (a) the company stands (whether by reference to security or otherwise) in the position of a creditor or debtor as respects any money debt; and
>
> (b) that debt is one arising from a transaction for the lending of money."

13. A "money debt" is defined as being a debt which falls to be settled:

> "(a) by the payment of money; or
>
> (b) by the transfer of a right to settlement under a debt which is itself a money debt …" (subs (2)).

14. Once a loan relationship is established the sums arising are dealt with in a self-contained calculation, for tax purposes, by the provisions of section 82:

> "(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."

Subsections (2) and (3) provide for different treatments of trading and non-trading receipts. I do not need to dwell on those.

15. Section 84 is an important section in this case because it deals with how debits and credits are to be brought into account. Under subsection (1) the debits and credits to be brought into account in respect of a company's loan relationships are the sums which:

> "in accordance with *an authorised accounting method* and when taken together, fairly represent, for the accounting period in question:
>
> (a) all profits and gains and losses of the company, including those of a capital nature, which … arise to the company from its loan relationships and related transactions; and
>
> (b) all interest under the company's loan relationship …".

16. The emphasised words bring in accounting standards and methods. If a company draws 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. This is where GAAP and the FRS's come into the picture in this appeal. The appellants (and particularly PLC for these purposes) say that they have presented their accounts in a GAAP-compliant manner; in the case of PLC the Revenue disputes that; and the FTT decided that point in the Revenue's favour.

17. Section 84(2) is important in terms of GKA's position. It leaves out of account sums required to be transferred to the company's share premium account:

> "84(2) The reference in subsection (1) above to the profits, gains and losses arising to a company—
>
> (a) does not include a reference to any amounts *required to be transferred to the company's share premium account*; but
>
> (b) does include a reference to any profits, gains or losses which, in accordance with generally accepted accounting practice, are carried to or sustained by any other reserve maintained by the company."

18. It will be remembered that on the transfer of the interest strip to GKA, GKA credited its share premium account with over £19m. GKA says that, whatever else might have been the position in relation to that amount of the value transferred, section 84(2) takes that £19m out of the calculation of profits for tax purposes.

19. Subsection (7) (which I do not need to set out here) provides that section 84 has effect subject to the provisions of Schedule 9, which itself contains some further detailed provisions about debits, credits and authorised accounting methods. The relevant provisions of Schedule 9 appear in the Appendix, and I shall take them up later in this Decision.

20. Section 85 deals with accounting methods, the significance of which I have just referred to. The "authorised" accounting methods are the accruals basis of accounting and a mark to market basis of accounting - section 85(1). Only the former is relevant to this case.

21. Subsection (2) provides conditions for the accounting method to be treated as authorised. It is authorised only if:

> "(a) subject to paragraphs (b) to (c) below, it is in conformity with *generally accepted accounting practice to use that method in that case*;
>
> (b) it contains proper provision for allocating payments under a loan relationship, or arising as a result of a related transaction, to accounting periods:
>
> …
>
> (c) where it is an accruals basis of accounting, it does not contain any provision (other than provision in respect of exchange losses or provision comprised in authorised arrangements for bad debt) that gives debits by reference to the valuation at different times of any asset representing a loan relationship."

22. The repeated reference to generally accepted accounting practice should be noted, and paragraph (c) is a provision relied on by PLC, as will appear. Subsection (3) contains provisions as to the operation of the accruals basis, of which paragraph (c) is the most significant one for this appeal:

> "(3) In the case of an accruals basis of accounting, proper provision for allocating payments under a loan relationship to accounting periods is provision which—
>
> (a) allocates payments to the period to which they relate, without regard to the periods in which they are made or received or in which they become due and payable;
>
> (c) assumes, subject to authorised arrangements for bad debt, that, so far as any company in the position of creditor is concerned, every amount payable under the relationship will be paid in full as it becomes due"

23. Section 86 contains further requirements for the application of accounting methods, and subsection (3) requires either that a proper accounting method be used, or if it is not used then an authorised method shall be used with which it equates:

> "(3) If a basis of accounting which is or equates with an authorised accounting method is used as respects any loan relationship of a company in a company's statutory accounts, then the method

> which is to be used for the purposes of this Chapter as respects that relationship for the accounting period, or part of a period, for which that basis is used in those accounts shall be—
>
> (a) where the basis used in those accounts is an authorised accounting method, that method; and
>
> (b) where it is not, the authorised accounting method with which it equates …"

Thus the significance of an authorised accounting method is emphasised again.

The Decision appealed from

24. The FTT's Decision determines three issues, corresponding broadly to the three issues identified above (though there was for a time a dispute as to what the Tribunal actually decided on the first one). Before turning to the particular issues it set out the background to the transaction and some of EY's marketing documents in relation to it. It then summarised the evidence of Mr Clifford, who was EY's audit partner and who gave evidence in that capacity. Since EY were the group's auditors his evidence was not treated as expert evidence. His evidence as to the treatment of the various sums in the accounts, and why they were treated in that way, was treated as factual evidence rather than as evidence of the correctness of what was done. Having set out the legislation and some of the accounting standards the Decision then turned to the three issues left in the hearing by then, and on each of them it set out the submissions of each side followed by a section which stated the FTT's own decision, usually relatively briefly. The issues it set itself to decide were issues which the FTT identified as being the relevant issues from PLC's skeleton argument (save for one in which the FTT substituted its own variant), so it is necessary for this appeal to consider the same issues.

Issue 2 and the findings on it

25. I call this Issue 2 because it is the nomenclature used below to describe the first of the three issues which I have identified above. There was an Issue 1, but that became an agreed matter before the hearing.

26. Issue 2 was defined in the following terms:

> "Whether PLC is taxable under section 84(2) of the 1996 Act [it is common ground that this is a mistaken reference and should be 84(1)]… on the £20,453,476 (the aggregate of the sums referred to in the closure notices) as a loan relationship credit. We are not required to decide whether the taxable amount, assuming it is taxable, has been correctly calculated."

27. The sum referred to is in effect (though not quite in amount) the net present value of the interest repayments which PLC transferred, and the amount by which the £300m recognised as the value of the loan in the books of PLC fell to be reduced (according to HMRC) and then accreted back over the period to the repayment date of the loan – the round £20.5m referred to above and below in this judgment. It is that accretion which HMRC said fell to be treated as a loan relationship credit. The issue therefore became whether or not it was necessary to reflect the transaction in that way in the company's accounts. If accountancy methods required that approach then the Revenue was correct. If they did not <u>require</u> it, but it was merely one of two or more ways of dealing with the matter in the accounts, then PLC was entitled to adopt another permitted method (including the method it actually adopted, namely one of maintaining the sum of £300m in its books and accounts even after the transfer of the interest strip), and the sum would not be taxable as a loan relationship credit.

28. Having set out the submissions of the parties on this point the FTT concluded as follows:

(a) It rejected the evidence of Mr Clifford, and Mr Parish (Greene King's accountancy expert) to the effect that no reduction of the £300m figure for the loan in the books of PLC (by way of derecognition) was required. In particular it rejected what it considered to be Mr Clifford's argument that no derecognition was required because the increased value of the investment in GKA was set off against any reduction in the value of the loan that might otherwise have been appropriate.

(b) It considered that those two accountants had failed to distinguish between "impairment" (appropriate if the loan was devalued because there were doubts about its recoverability) and "discounting because of time lapse before payment" ("derecognition", in the parlance of the case). Full recognition of the loan failed to reflect accurately PLC's own position, disregarding its subsidiaries. A true and fair value of the loan as at the date of the assignment was a discounted value, and that value increased by accretion as the redemption date approached.

(c) It agreed with Mr Chandler, HMRC's expert, that the applicable standards (FRS 5 paras 23 and 71, see below) applied and no departure from those standards (which required derecognition of part of the value of the loan) was warranted. The reality of PLC's position (which the accounts should reflect) was reflected by partially derecognising the loan and adding to the investment in subsidiaries. PLC's accounting treatment (leaving the £300m fully recognised) was not GAAP compliant.

(d) PLC was therefore required by UK GAAP to de-recognise the loan principal, accrete the amount back up to its full loan value over the period to redemption and take that accreted amount into profit in that period.

29. The FTT recorded its final decision in paragraph 94. Instead of recording that it determined Issue 2, as framed, in favour of the Revenue, it recorded its determination as follows:

> "Issue 2: PLC was required by UK GAAP to de-recognise the loan principal, to the extent necessary to reflect its current value at the date of the assignment, and to bring a sum equivalent to the difference between the amount so determined and its face value into profit over the remaining period before redemption. We do not determine whether the amount by which the principal should have been de-recognised and the NPV of the interest strip at the date of the assignment are identical, but leave the parties to agree on that point, or to return for further argument should that be necessary."

30. That answer does not match the question. It suggests that it treated the derecognition question as being the only question that fell to be decided, and that is also the impression given by its decision section on the point earlier in the Decision. It leaves it open to Mr Gardiner to complain that the FTT did not deal with various other points that were argued and that had to be decided before one could arrive at an answer to Issue 2 as framed.

31. At one stage Mr Gardiner seemed to raise a dispute as to what it was that the FTT decided on this issue. He pointed to what he said was a discrepancy between paragraph 74 of the Decision, taken with paragraph 94, and a subsequent "Decision Notice" which Judge Bishopp issued in the context of an application to stay the decision pending an appeal. At one point Mr Gardiner suggested that the later document seemed to indicate that the FTT had decided less than the written Decision indicated they had. However, Mr Gardiner resiled from that position, and it is now common ground that the decision is to be found in the main document (though Mr Gardiner did continue to submit that the later document indicated that the FTT did not realise that it had to decide more than it did decide).

The appeal on Issue 2

32. Mr Gardiner says that those findings are wrong for the following reasons.

(a) Even if the approach of HMRC and the FTT was right as to the need to derecognise part of the loan value, it was still wrong to say that that gave rise to a taxable profit or gain because on the facts there was no such profit or gain, and/or various statutory provisions operated so as to prevent the derecognition and accretion of the loan for tax purposes even if it was required for accounting purposes by GAAP. I shall come to the detail of this in due course. It is said that these points were argued before the FTT but not ruled on.

(b) The FTT was wrong to say that GAAP required the derecognition and accretion. It was open to PLC, within proper accounting standards or methods, to draw its accounts as it did, with no sum being credited to profit and loss accounts. The decision did not accord with the accountancy evidence, it did not address all relevant issues of accountancy, held PLC to a higher standard than it was obliged to meet and was a decision not reasonably open to the FTT on the evidence.

(c) He relied on various other statutory provisions which, he claimed, stood in the way of the approach of HMRC and the decision of the FTT, though again the FTT did not rule on them.

33. The first of those attacks assumes the general approach of the FTT on what accountancy standards required to be right. The second seeks to demonstrate that it was wrong. I prefer to deal with those points the other way round.

The criticism of the Decision in relation to Issue 2 – general

34. Mr Gardiner submits the Decision of the FTT on the point was flawed. He submits that its application of, and approach to, the evidence was wrong. At the heart of the FTT's decision on the point was a finding that PLC's accountancy method was not GAAP-compliant. That finding was wrong.

35. It is apparent that the FTT reached its conclusion having heard expert witnesses on the point. It had an expert from HMRC (Mr Chandler) expressing the view (from which he did not repent) that GAAP required (and not merely allowed as one of a number of approaches) the approach of HMRC, that is to say derecognition of part of the loan value and an accretion back up to £300m, taking the accretion to profit and loss account. It had an expert expressing the contrary view (Mr Parish), supported to a degree by Mr Clifford. It preferred the analysis of the Mr Chandler. Thus described, the decision would seem to be one with which an appellate tribunal should not interfere. However, Mr Gardiner submitted that interference was justified because (re-structuring his above analysis):

(i) The FTT erred in saying that the proper application of GAAP justified derecognition of part of the loan and the accreting back over the period to redemption, and further failed to address the question whether GAAP required such treatment (as opposed to treating it as one of two or more ways of addressing the point).

(ii) Even if there was derecognition the result of accreting back ought not to have been taken to profit and loss account, or to taxable profits. The FTT's decision did not deal with this point despite the fact that there was expert evidence on it (from both sides).

(iii) There was no realised profit on the transaction to be taken to profit and loss account. The FTT's decision did not deal with this point either, despite expert evidence.

(iv) The approach of derecognising and accretion was not permitted by the statutory provisions relating to loan relationships.

Mr Gardiner's point (i) - whether GAAP required the FTT's approach to derecognition

36. The FTT's decision on this point is contained in paragraphs 71 to 74 of its Decision. Its reasoning can be summarised as follows. Mr Clifford had reasoned that derecognition was not required because the overall economic and commercial effect of the assignment, being one in favour of a subsidiary, was such that PLC's overall position was not affected. He did not consider that FRS 5 required partial derecognition in the circumstances. PLC had not suffered a loss; merely a change in the nature of the assets that it held. The FTT rejected this as a reason for not derecognising the loan, and considered that Mr Clifford, and Mr Parish, had failed to distinguish between impairment on the grounds of doubtful recovery and discounting a value because of a lapse of time until payment. It was "axiomatic" that the value of the loan without the interest was less than the value of the loan with interest. A true and fair value of the asset at the date of the transaction was that it was worth £280m, not the £300m. There was no basis for departing from FRS 5 (FTT Decision paragraphs 23 and 71). In the circumstances HMRC were right to argue that partial derecognition was required and that PLC was obliged to bring the accretion into taxable profit. It therefore decided Issue 2 in the Revenue's favour.

37. I can dispose first of Mr Gardiner's point that the FTT did not deal with the question of whether HMRC's approach to this point was the only GAAP-compliant way of dealing with it or whether it was one of two or more ways, with PLC's being a permissible alternative. It is true that the Decision did not in terms address this point, but it is plain enough from the terms of the Decision that it rejected the Clifford/Parish approach as a permissible GAAP-compliant approach. It is implicit in the wording of the Decision that the FTT considered that the proper application of GAAP and any other relevant accounting principles was to derecognise and accrete, and the proposed alternative was not compliant. I shall therefore consider the Decision on that footing.

38. I therefore turn to the submission that this conclusion was wrong. In this appeal Mr Gardiner started his written submissions on this point by implicitly acknowledging that the starting point of the Tribunal's finding might be thought to be the acceptance of the evidence of one expert over another. If that is right then there is an obvious hurdle for PLC to overcome in challenging the findings. He also accepts that he has an appeal to the Upper Tribunal on questions of law only. However, he seeks to overcome these obstacles by saying that the FTT did not give reasons for their decision, which is itself a flaw (relying on *Flannery v Halifax Estate Agents* [2000] 1 WLR 377 at p 382); by saying that such reasoning as exists is inadequate on compliance with GAAP; that it does not address all the accountancy issues that arose (especially on whether there was a realised profit or gain); and that it applied the wrong test in relation to GAAP. Alternatively, the decision it reached was not reasonably open to it on *Edwards v Bairstow* principles.

39. His first point is that the FTT were wrong to say that GAAP *required* the derecognition of the £20.5m in relation to the loan. That might have been one permissible accounting treatment, but there are others, including not derecognising it, as PLC did. The key accounting standard was FRS 5, and in particular paragraphs 23 and 71, and what Mr Parish (and Mr Clifford) were doing was considering the application of that standard as a matter of judgment, which they were entitled to do. They were not, as Mr Gardiner says the FTT thought they were, departing from it. The only conclusion properly open to the FTT was that PLC was entitled to conclude that partial derecognition was not required. The FTT did not really engage properly with this debate, and instead confused the mechanism for arriving at an amount of derecognition (subtracting the discounted value of the alienated interest) with the question of whether it should have been derecognised at all. Furthermore, the FTT seemed to have thought that PLC was departing from FRS 5 (which it was not doing), rather than applying it in a justifiable way (which is what it was doing and which the expert evidence said it was entitled to do). The FTT itself failed to address some of the relevant questions arising under FRS 5. Putting it shortly, the FTT misunderstood and misapplied the accounting standards.

40. In embarking on a consideration of this limb of this appeal it is useful to bear in mind two important points:

(i) HMRC accepted that its case was based on a single correct implementation of accounting standards, with no other view being correct. That enabled it to submit that the accounts of PLC were non-compliant in terms of GAAP. Mr Milne accepted that if it were in fact the case that HMRC's (and Mr Chandler's) view on derecognition was just one justifiable view, and that PLC's (and its accountants' and expert's) view was also a justifiable view, then the FTT decision on the point could not be justified. This follows from the references to compliance with accounting standards in the statutory provisions set out above. If it was possible to comply with accounting standards in two possible ways, one of which involved derecognition and one of which did not, then PLC was entitled to adopt the latter, and it did.

(ii) The two experts agreed that the accounting guidance in FRS 5 ("Reporting the substance of transactions") should be "considered" (their word). In fact they did not just "consider" it; the approach adopted by them seems to have been one involving ascertaining the proper interpretation of the standards, and then applying them as if they were formal rules and the only material to which one turned in ascertaining how to reflect the assignment of the interest. Mr Chandler took the view that, on the facts of this case, that process generated only one proper answer, which was that derecognition was required. Mr Parish and Mr Clifford took the view that their terms allowed the view that derecognition was not required. The FTT (in paragraph 74) held that "a departure from FRS 5 is not justified". It therefore implicitly found that what PLC had done was not within FRS 5 - that that standard pointed to one result and one result only. The appeal on the point currently under consideration can therefore be approached on the footing of what FRS 5 said.

41. The purpose of FRS 5 is set out in a Summary at the beginning:

"Financial Reporting Standard 5 'Reporting the Substance of Transactions' requires an entity's financial statement to report the substance of the transactions into which it has entered.

"The FRS … will mainly affect those more complex transactions whose substance may not be readily apparent. The true commercial effect of such transactions may not be adequately expressed by their legal form and, where this is the case, it will not be sufficient to account for them merely by recording that form."

Transactions requiring particularly careful analysis will often include features such as—

> "… a transaction linked with others in such a way that the commercial effect can be understood only by considering the series as a whole.…"

42. The decision of the FTT did not cite the first sentence of this, but it is apparent from other citations that it was aware that the purpose of the FRS was to achieve a proper reporting of substance.

43. Paragraphs 23 and 71 are of particular relevance. They deal with what should happen when there are transactions which affect previously recognised assets, and were identified as being relevant in the FTT's decision which sets them out in paragraphs 46 and 47 of the Decision. Although the Decision did not set out the paragraphs which precede paragraph 23 they do provide a context (and some wording) which is necessary to make full sense of the evidence in the case. Those paragraphs, and paragraph 23, read:

"Transactions in previously recognised assets

Continued recognition of asset in its entirety

21. Where a transaction involving a previously recognised asset results in no significant change in –
(a) the entity's rights or other access to benefits relating to that asset, or
(b) its exposure to the risks inherent in those benefits,

the entire asset should continue to be recognised ...

Ceasing to recognise an asset in its entirety

22. Where a transaction involving a previously recognised asset transfers to others –
(a) all significant rights or other access to benefits relating to that asset, and

(b) all significant exposure to the risks inherent in those benefits,

the entire asset should cease to be recognised.

Special cases

23. Paragraphs 21 and 22 deal with most transactions affecting items previously recognised as assets. In other cases where there is a significant change in the entity's rights to benefits and exposure to risks but the provisions of paragraph 22 are not met, the description or monetary amount relating to an asset should, where necessary, be changed and a liability recognised for any obligations to transfer benefits that are assumed. These cases arise where the transaction takes one or more of the following forms:

> a transfer of only part of the item in question;
>
> a transfer of all of the item for only part of its life;
>
> a transfer of all of the item for all of its life but where the entity retains some significant right to benefits or exposure to risks."

44. Paragraph 25 deals with what is "significant":

"25. In applying paragraphs 21–23 above and paragraph 26 below, 'significant' should be judged in relation to those benefits and risks that are likely to occur in practice, and not in relation to the total possible benefits and risks."

45. Paragraph 71 indicates how to deal with transfers of part of an asset (as is the case here):

> "71. Transfer of part of an item that generates benefits may occur in one of two ways. The most straightforward is where a proportionate share of the item is transferred. For example, a loan transfer might transfer a proportionate share of a loan (including rights to receive both interest and principal), such that all future cash flows, profits and losses arising on the loan are shared by the transferee and transferor in fixed proportions. A second, less straightforward way of transferring a part of an item arises where the item comprises rights to two or more separate benefit streams, each with its own risks. A part of the item will be transferred where all significant rights to one or more of those benefit streams and associated exposure to risks are transferred whilst all significant rights to the other(s) are retained. An example would be a 'strip' of an interest-bearing loan into rights to two or more different cash flow streams that are payable on different dates (for instance 'interest' and 'principal'), with the entity retaining rights to only one of those streams (for instance 'principal'). In both these cases, the entity would cease to recognize the part of the original asset that has been transferred by the transaction, but would continue to recognise the remainder. A change in the description of the asset might also be required."

46. The FTT summarised the point of these as follows:

> "We repeat, for ease of understanding, that the critical point, in relation to Issue 2, is whether the combined effect of paras 23 and 71 of FRS 5 is to require PLC to derecognise the capital value of the loan principal in part, as HMRC contend; or, as the appellants maintain, their effect is to require PLC to produce accounts which do not contain any element of derecognition." (paragraph 48).

47. Also in evidence, and relied on by the experts, was note E15 to that FRS. It occurs in a section headed "Derecognition", which starts at note E13 (not cited by the FTT):

> "E13. Derecognition (i.e. ceasing to recognise the loans in their entirety) is appropriate only where the lender retains no significant benefits and no significant risks relating to the loans. In determining whether any benefit and risk are retained are 'significant', greater weight should be given to what is more likely to have a commercial effect in practice."

48. Paragraph E15 then elaborates on that theme:

> "E15. Whilst the commercial effect of any particular transaction should be assessed taking into account all its aspects and implications, the presence of all of the following indicates that the lender has not retained significant benefits and risks, and de-recognition is appropriate:
>
> (a) the transaction takes place at an arm's length price for an outright sale;
>
> (b) the transaction is for a fixed amount of consideration and there is no recourse whatsoever, either implicit or explicit, to the lender for losses from whatever cause …
>
> (c) the lender will not benefit or suffer in any way if the loans perform better or worse than expected …
>
> Where any of these three features is not present, this indicates that the lender has retained benefits and risks relating to the loan and, unless these are insignificant, either a separate presentation or a linked presentation should be adopted."

49. Paragraph 52 of the Decision summarised the principal dispute arising out of these provisions in this way:

> "52. The main battleground was, as it is in the appeal itself, whether or not the loan should have been partially de-recognised. It was common ground between the experts that, had the transfer of the interest strip been between unconnected parties, it would ordinarily have been appropriate for its value to be de-recognised in accordance with FRS 5, paras 23 and 71, in order that the financial statements gave a true and fair view."

50. That summary was not disputed at the hearing before me, and the recital of common ground seems to be accurate.

51. In paragraphs 53-56 of the Decision the FTT sought to summarise the expert evidence as a result of this material. It summarised Mr Parish as saying that there was no "impairment" of the "overall value of PLC's investment in GKBR following the transfer of the right to interest", and it would be appropriate for the loan to be accounted for in the same manner as other intra-group loans on which there was no direct economic return, which was at redemption value. If PLC did not continue to reflect the full value of the principal in its accounts (which were solus, not consolidated, accounts) a misleading impression would be given to the effect that it was not entitled "overall … to the full beneficial interest in that principal". Derecognition was not required by FRS 5 paras 23 and 71 because not all the features in note E15 were present.

52. Mr Chandler was summarised as taking the contrary position. He considered that unless there was a compelling reason requiring the contrary - and there was none in that case - partial derecognition was mandatory under paragraph 71. This was not a demand loan; the principal was not repayable for 15 months. Impairment had nothing to do with it; what was required was that the accounts should reflect the present value of a sum payable in the future, and then there should be an accretion over time as the date for payment approached. The accretions would be taken to profit and loss account. He relied on supporting guidance from three of the "Big Four" accountancy firms.

53. I have already outlined the reasoning of the FTT in paragraphs 71 to 74 of its Decision. Mr Gardiner said that what he described as its "primary reasoning" (in paragraphs 71 to 73) was not espoused or enhanced by any expert. The approach was said to be plainly at odds with the "fundamentals" of FRS 5. At first sight there might be thought to be something in the first of those criticisms. The FTT seems to have considered that the mere fact, taken by itself, that the loan had a lesser value as a result of the transaction, meant that part of its value had to be derecognised, whereas some of the debate between the experts was more subtle than that and took into account the retention of benefits and liabilities. However, on one reading of Mr Chandler's report he starts his reasoning by relying basically on little more that the fact that the disposal of the interest strip did indeed have the effect of devaluing the principal, and that that should be reflected in the accounts. Accordingly, this part of the decision could be said to be in accordance with that expert evidence.

54. However, the real meat of this part of the appeal lies in the Tribunal's approach to the case made in relation to the paragraphs of FRS 5 referred to above. The Tribunal dealt with this in paragraph 74:

> "74. We agree too with Mr Chandler and Mr Milne that there is no ground on which a departure from the terms of paras 23 and 71 of FRS 5 is warranted; on the contrary, we consider they are directly in point. From the moment of the assignment, PLC no longer had the right to receive the interest; it had instead a more valuable subsidiary. It is irrelevant that this was not an arm's length transaction or that PLC could have undone the assignment at any time; accounts must reflect the position as it is, and not as it might be. For these reasons we perceive no need, as the appellants contend, to reflect the fact that PLC's overall position is unchanged by declining to de-recognise part of the loan. The reality of the transaction is properly reflected by partial de-recognition of the loan, and an addition to the value of PLC's investment in its subsidiaries. That being so, a departure from FRS 5 is not justified, and it follows that the accounting treatment of the transactions adopted by PLC is not GAAP-compliant. Thus HMRC are right to argue that partial de-recognition was required by UK GAAP, that PLC was obliged to bring the accretion from the NPV of the capital sum on the date of the assignment of the interest strip until redemption into taxable profit, and that issue 2 must accordingly be determined in HMRC's favour."

55. The case of PLC on this appeal is that this betrays a misunderstanding of what the case of PLC was. It (and Mr Parish) was not saying that there should be departure from the terms of paragraphs 23 and 71. PLC's case was that those paragraphs were complied with in its accounting. PLC said this was because Mr Parish was of the view that the economic and commercial substance of the transaction (which is what the accounts had to reflect) was reflected by leaving the whole of the loan recognised. Because the transfer of the right to interest was to a group company there was no disposal of all the rights and benefits. PLC remained exposed to the risk that the loan value could fall, because of the interest that it had in the subsidiary, and it had some control over the interest because of its control over the subsidiary. The case of PLC very much hinged on this degree of connection. It is said that Mr Parish's view implemented the provisions of FRS 5, particularly in the light of note E15. The FTT had failed to look at the transaction as a whole, and to recognise that PLC's rights as the holding company (and not just the effect on the value of the loan) had to be taken into account and in failing to do that it had not viewed the series of transactions as a whole.

56. I remind myself that the FTT heard a lot of evidence about the proper accounting treatment of this limb of the transaction. It was entitled to consider and weigh the expert evidence that it heard. The experts took diametrically opposing views. They were based on diametrically opposing views of what FRS 5, and recognising the substance of the transaction, required. If the FTT reached its conclusions by accepting the evidence of

one expert rather than the other, then there are well known obstacles (acknowledged by Mr Gardiner, as I have said) to a challenge to that decision.

57. The first question is whether the FTT did reach its conclusions in that way. In my view paragraph 74, in its context, demonstrates that it did. The first sentence probably gets the emphasis wrong. The debate between the parties was not so much whether a departure from FRS 5 was warranted. The debate was rather as to what was required in order to comply with it. Both sides said their treatment complied, and indeed they seemed to be saying that any other treatment would not comply. Neither accepted that the other side's view was arguable. So the choice was as to which side was correct, based on expert evidence. The first sentence indicates clearly enough that the FTT preferred Mr Chandler's views. That also appears from the sentence:

> "The reality of the transaction is properly reflected by partial de-recognition of the loan, and an addition to the value of PLC's investment in its subsidiaries."

That is a finding as to the substance of the transaction, in the circumstances, and reflects Mr Chandler's views. The FTT had already recorded the views of the experts, and apart from an erroneous reference to "impairment" in referring to Mr Parish's evidence (an error probably brought about by the experts' occasionally perpetrating the same error) they recorded the experts' positions accurately enough. Looking at the paragraph as a whole, and placing it in its context, I think it is right to read it as an acceptance of the evidence of Mr Chandler in preference to the evidence of Mr Parish; that is to say, the FTT considered that the substance of the matter was properly reflected by derecognising part of the loan value, and it did not accept Mr Parish's view that the contrary was correct. While it did not make a finding that Mr Parish's view was not even an alternative justifiable view, it must be taken to have found that it was not.

58. That being a finding of that nature, Mr Gardiner needs to establish that it was not a finding open to the FTT on the evidence. His submissions, on analysis, suggest the following bases for arriving at that conclusion:

(i) Mr Chandler's evidence did not provide clear evidence on which the FTT could have arrived at their decision.
(ii) If one looks at the key point, which is FRS 5, it points the other way and does not support the decision.

59. As to (i), Mr Gardiner first pointed to statements in Mr Chandler's report which, he said, indicated that Mr Chandler had expressed the view that PLC had confused consolidated company accounts with solus company accounts. This criticism is ill-founded. While it is true that Mr Chandler does refer to consolidated accounts in his paragraph 4.26, it is apparent that in doing so he is not betraying any confusion. The preceding paragraph sets out correctly the argument of Mr Parish that the benefits coming from the increased value in GKA meant that PLC's exposure had not significantly changed. Mr Chandler disagreed with that analysis because he said that such a "consolidated approach"

(wording he used in paragraph 4.26) was not, in his view, correct. He said the standards required looking at PLC's accounts alone (which Mr Parish agreed with) and that the proper analysis was that a different set of rights and cashflows had arisen. While he did refer to "consolidated accounts" he was obviously looking at the sort of consolidated position inherent in Mr Parish's stance, and rejecting it. It is quite plain that he understood that Mr Parish was not looking to consolidated accounts as such, and he was right about that.

60. Mr Gardiner then went on to criticise an assertion by Mr Chandler to the effect that if PLC's interpretation of FRS 5 was correct all intra-group transfers would fall to be ignored. Even if that was what Mr Chandler was saying that does not undermine the validity of his view of the correct approach to derecognition; and in any event in my view there is something in the point which is said to flow from Mr Chandler's view. Last, Mr Gardiner complained that Mr Chandler sought to justify his position on a number of bases which were not foreshadowed in his reports or put to Mr Parish, and were flawed. Whether or not that is the case, that does not disqualify the whole of his evidence, or disentitle the FTT from relying on it.

61. Turning to point (ii), it is necessary to consider FRS 5. Much of Mr Gardiner's submissions, on analysis, involved averments that the Tribunal itself misapplied FRS 5, and adopted a wrong approach to whether all significant rights and exposure to risks had been transferred in respect of the interest strip (see FRS 5 paragraph 71). The case of the appellant revolved around the position that the requirements of the paragraphs of FRS 5 identified in this Decision meant that there was no case for derecognition because the three "tests" in note E15 were not fulfilled. That meant that it could not be said that PLC had divested itself of all benefits in respect of the loan, so that under FRS 5 derecognition was wrong, and was not justified.

62. Bearing in mind that the taxing statute permits assessments on the basis of accounts that are within acceptable accountancy standards, it is necessary to consider whether FRS 5 does indeed allow the continued showing of the loan at its full value in accounts of the company, or requires the contrary. This was really the question which the experts addressed, and on which the FTT would have received, and relied on, expert evidence. However, since Mr Gardiner also ran the more direct approach (inviting a direct consideration by the Tribunal of how the FRS applied) I have considered it.

63. Having done so I consider that Mr Gardiner's argument fails. The avowed purpose of FRS 5 is to assist a determination of whether the accounts of the company present a proper picture of the position of the company having regard to the commercial substance of any transactions. Mr Gardiner's submissions tended to treat paragraph E15 as if it was a code to be applied without reference to other circumstances. His submissions (and, as far as I can see, the position of Mr Parish) proceeded on the footing that if any one or more of the 3 factors listed in that paragraph are not present, then it would automatically be assumed that benefits or liabilities had been retained and that derecognition was not appropriate. That does not seem to me to be the way in which the paragraph works.

64. The Purpose of the parts of the FRS relied on in the proceedings was to make sure that the substance of the transaction was properly recorded. The purpose of paragraph E15 is to give guidelines, not rigid requirements, for determining whether the substance of a transaction involved sufficient parting with benefits or liabilities to change the substance of the position "relating to the loan". It was doubtless aimed at a situation in which a company retained liabilities via such matters as warranties, or in which a company might get a benefit from a future realisation of a loan whose benefit it had otherwise assigned. That sort of situation does not exist in the present case. What happened in the present case is that, as a matter of substance, the rights to interest to the end of the loan were disposed of. What also happened, as a matter of substance, was that PLC acquired preference shares in its subsidiary. The commercial substance of the transaction was plainly, in my view, a transaction with those two separate albeit commercially connected limbs. 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 value of the loan might be said to be reflected by an increase in value of its shareholding in the subsidiary. However, <u>in relation to the loan</u> the real substance of the transaction was that the loan had become less valuable. 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. The whole scheme of PLC required such substance. As a matter of legal and commercial reality, that was achieved. The effect of that is that <u>in relation to the loan</u> (to paraphrase the expression "relating to the loan" used in notes E13 and E15) the correct reflection in the accounts of the company, in order to present a true and fair view, is to reflect the change in assets in the manner proposed by Mr Chandler (derecognition).

65. In this connection I do not consider that paragraph E15 provides a mechanistic code. It provides indicia which would assist in determining whether there should or should not be derecognition, but not an automatic mechanism. Accordingly, the absence of one or more of the criteria in that paragraph is not fatal to the case for derecognition.

66. Accordingly, insofar as the submissions of Mr Gardiner invited a finding that the proper implementation of paragraph E15 required continued recognition in full, I find that he was wrong.

67. In all the circumstances, therefore, I find that this first point of PLC fails. The FTT was entitled to find derecognition was required in the circumstances of this case, and looking at the FRS, I agree with the FTT.

Mr Gardiner's point (ii) - any accretion back to £300m should not be taken to profit and loss account

68. It is as well to start by considering what the FTT decided about this. Most of its reasoning on the derecognition/accretion point concerned the need (or otherwise) to derecognise. It came to the conclusion that one should – see paragraph 74 of its Decision, above. It seems to have assumed that once one derecognised, it automatically follows that (first) there had to be an accretion back to £300m and (second) that accretion

fell to be taken to profit and loss account and (third) that it fell into taxable profit. It is plain just looking at the experts' reports that they did not both agree that those consequences followed from derecognition. Mr Chandler considered that they did; Mr Parish did not. They acknowledged that the question might involve questions of law rather than accountancy, but they expressed views nonetheless. The FTT did not consider this difference. They seem to have considered that there was an automatic progression through the stages.

69. Mr Milne resisted that conclusion. He submitted that, by implication, the FTT accepted the analysis of Mr Chandler which had the consequence that the amount of the accretion fell to be taken to profit and loss account. I do not accept that submission. While it is plain that in various respects they preferred Mr Chandler's evidence and analysis to that of Mr Parish it does not follow that they accepted all his reasoning. The terminology of this part of the Decision does not really admit of the inference that they accepted it in this area. It is just not plain enough that they did. They have not set out their reasons for getting to their conclusion, and the terms of the Decision suggest they thought it was a matter of simple logic with no-one arguing otherwise.

70. That means that there is an error in the FTT's reasoning. Filling that gap requires some consideration of competing expert evidence, so I have to consider whether it is for me to fill that gap on this appeal or whether the point should be remitted to the FTT to consider it further.

71. Neither party expressed any enthusiasm for a remittance to the FTT at the main hearing before me, and Mr Gardiner maintained his stance that I should deal with such issues as he raised even if they involved a consideration of the accounting evidence which the FTT did not make findings about, or even deal with at all. Mr Milne seemed to share that view at the main hearing, though at one point in his latest skeleton he submitted (while saying that the position was straightforward) that if the accounting evidence needed to be reconsidered then it would be more appropriate to remit. I did not detect much enthusiasm or vigour behind that submission. I have decided, with some reluctance, that I should deal with the points myself. My reluctance stems from the lack of assistance that I originally received on the point. While these questions were debated between counsel, some of them at length, they tended to be the subject of assertion by counsel as to what the analysis should be as if it were somehow obvious or plain, without the necessary reference to the detail of the expert evidence below. That evidence comprised original reports, supplementary reports and an agreed statement, together with significant cross-examination. A full consideration of that evidence, such as ought to have occurred in the FTT, requires the clear identification of all the relevant parts of the evidence so that I could easily find that evidence and consider it in the manner which would have been open to the FTT. I did not receive that degree of assistance until the matter was restored by me for further argument. In an additional skeleton argument prepared for that hearing Mr Gardiner prepared a summary and listing of the parts of the evidence that he said were relevant to these issues. Mr Milne did not do the same, though he commented on Mr Gardiner's listing without complaining about any incompleteness so I have assumed Mr Gardiner's listing is correct and worked from that (and other parts of the original reports

of the experts). As a result I believe I can act fairly to the parties, and properly in an appellate jurisdiction, in deciding the point.

72. According to a document prepared by PLC for the hearing below, Mr Parish and Mr Chandler agreed that if there was derecognition then it would be appropriate to accrete the lower sum back up to the amount of the principal of the loan over the remainder of its lifetime. (Both experts agreed, for their own differing reasons, that it was not appropriate to take the derecognition amount as a loss.) So that step in the logic is out of the way. The difference between the experts was as to whether that increase was to be taken to profit and loss account. Mr Chandler's case was relatively simple - it would. Mr Parish's answer was that it would not. He said the proper accounting treatment was to treat the amount of derecognition as an increase in the value of the subsidiaries, and then to offset the accretions against that increase. In the words he used in an agreed statement of the experts:

> "Mr Parish's opinion is that as the accretion does not represent a realised profit then it would be appropriate for the value of the accretion to be offset against the carrying value of PLC's investment in its subsidiary companies rather than included as income in its profit and loss account."

73. I shall come back to the question of "realised profit" shortly, because it is another point that divides the parties, and for the time being deal with the second part of this analysis - the offset against the carrying value of the subsidiaries. Mr Parish's treatment of the derecognition (assuming it has to be done, which he of course disputed) was to treat the balancing item as an investment in subsidiaries. It is against that that he was offsetting the accretions. (That was also the way that Mr Clifford would have reflected the matter, on the assumption that derecognition and accretion were required.)

74. Mr Parish was not cross-examined on this point, but Mr Chandler was. His response was to say:

> "So I don't see why you would diminish that investment when it's entirely supported by reference to cashflows received in that subsidiary [i.e. GKA]." (Day 3 p34).

I agree with him. I have reviewed the evidence and not found Mr Parish's thesis at all understandable. It has no logic about it. When I asked Mr Gardiner about a part of Mr Parish's report which set out his view on the point even Mr Gardiner was not, at the time, able to explain what was meant. He returned to the point in his reply on the occasion of the further submissions. He was unable to make the point more understandable, or logical, then. His argument seemed to be that if the derecognition was matched with the increase in the value of the subsidiaries, the "recapture" (his word) of the deduction means the cost of the investment itself has been recaptured. I do not accept that argument. PLC has put £20.5m into the subsidiary. The value of its asset (the loan) has been reduced. That asset recovers its value over time, but that is not a recovery of the cost of the investment. PLC is still £20m worse off in relation to the loan because it has assigned the interest rights and it never recovered that money. It remained outstanding in its subsidiary.

75. Accordingly, the only alternative to Mr Chandler's treatment can be seen to be illogical and wrong. Since there is no alternative, Mr Chandler's treatment of the accretion must be correct. It seems to me to be correct in principle anyway.

76. Mr Gardiner had another point on whether the result of the accretion should properly be treated as a profit. I deal with it below in the context of a submission made in relation to section 84(1). I find him to be wrong in those submissions.

77. Mr Gardiner therefore fails on this point.

Mr Gardiner's point (iii) - no realised profit

78. This point was again not dealt with by the FTT, despite having been raised in the hearing below. It comes in at a number of levels of the debate, but is central to the cases of both parties. It is common ground that the accretion-back amount only falls to be taken to profit and loss account if it is a "realised profit".

79. HMRC says that it is. The experts agreed that the proper form of accountancy guidance was an ICAEW document known as Tech 07/30. It sets out a number of circumstances in which a profit can be said to be "realised". One of them is the receipt of cash. That is relied on by HMRC - it says cash was received when the loan was redeemed. There was a profit because £300m was received in respect of an asset which had a value of £279.5m. That is a profit.

80. PLC disputes that. Mr Parish's view was that there was no realised profit because cash was not received in a relevant sense, and there was no reversal of a previous realised loss. The latter point does not matter for present purposes - no-one was saying that there was. Mr Parish's main point was that when PLC received £300m it was doing no more than receiving an amount equal to the nominal value of the loan note.

81. I consider that HMRC is right about this. As a result of the accretion (and repayment) PLC has obtained a profit, and it is a realised profit because it is received in cash. Because this point is, as a matter of analysis closely linked with the question of whether there was any sort of profit or gain, and since that latter question arises under the next section of this judgment, I shall deal with my further reasoning on the point in that section.

Point (iv) - statutory provisions and related matters

82. Mr Gardiner then advanced a series of submissions based on the footing that the decision that GAAP required derecognition and accretion back up to £300m was correct and pointed to a number of other statutory provisions. He said that they had the effect that the accretion should not fall to be treated as profits within the regime applicable to loan relationships. At the heart of his submission was the proposition, not disputed by the Revenue in general terms, that the loan relationship provisions of the legislation contained a self-contained code applicable to loan relationships.

83. Several of these points were (again) not dealt with by the FTT even though they seem to have formed part of the argument below. Since they are points of law I was invited to decide them anyway because they are all relevant.

Statutory provisions - no profit or gain (and "realised profits" further developed)

84. This is another point not dealt with explicitly in the FTT Decision.

85. Mr Gardiner's point under this head was that the derecognition did not give rise to a "profit" or "gain" within section 84(1)(1). It is only profits and gains within that subsection that fall to be taken into account. These are separate concepts in relation to what might be <u>accounting</u> profits and gains and amounts should only be taken into account if it can be shown that they fairly represent a profit or gain (or loss, if relevant). Once that is appreciated, it can be seen that the only relevant return that PLC actually received was (apart from historical interest from GKBR) the special dividend, the preference shares (with a nominal value of £1.5m) and repayment of the principal. Since the Revenue had abandoned its claim to tax the £1.5m value of the shares (which it had), the only relevant returns were the special dividend. The Revenue, however, sought to tax both the special dividend and the £20.5m accretion back to £300m. This was illogical - it would compel the conclusion that if full cash value had been obtained for the assignment of the interest, PLC would have been taxed on both the accretion and the full value - it would have been taxed twice on the same amount. It is obvious that the only profit received is the amount of the special dividend.

86. This point is related to the "realisable profit" point, but it has a potential statutory twist. Under the loan relationship code

> "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, in accordance with an authorised accounting method when taken together, *fairly represent*, for the accounting period in question—
>
> (*a*) all profits, gains and losses [etc]." (section 84)

87. I have italicised words which assumed a greater importance when this point was debated at the resumed hearing as a result of my request for elaboration of the submissions. Both parties referred on that occasion to *DCC Holdings (UK) Ltd v Revenue and Customs*

Commissioners [2010] STC 80 (CA) and [2011] 1 SLR 44 (SC). In that case Moses LJ considered that the correct approach was first to consider the application of an accruals basis of accounting and then consider the application of "the second criterion, fair representation" (para 22; see also para 13). That suggests a sort of statutory override.

> "The section poses a second statutory question, namely whether any particular sum when taken together with the other sums which fall to be brought into account fairly represents all the interest including that which is the mere product of a statutory fiction." (para 63).

88. It is plain that Rix LJ also held that the wording of the section requires an assessment of fair representation. In the Supreme Court Lord Walker doubted that the section contained two criteria, and held that it had to be construed as a whole (see para 35), but that still leaves the effect of the section as having a "fairly represents" requirement within it.

89. Mr Gardiner submitted that the expressions "profits" and "gains" had a legal meaning hallowed since 1799. He cited the judgment of Fletcher Moulton LJ in *Re Spanish Prospecting Co Ltd* [1911] 1 Ch 92 at 99:

> "We start therefore with this fundamental definition of profits, namely, if the total assets of the business at the two dates be compared, the increase which they shew at the later date as compared with the earlier date (due allowance of course being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question."

90. Mr Milne opposed any reference back into history - his submission was that the relevant exercise was to ascertain what were the profits by applying correct accountancy principles, applying in particular the discrete code applicable to loan relationships. However, in the end he also said this was a matter for the court and I did not detect any difference between him and Mr Gardiner as to how one ascertained profits for these purposes.

91. Mr Gardiner's main point under this head was the one which I have already mentioned above under "realisable profits". He submitted that Mr Chandler arrived at a credit of £20.5m (treated as a profit) by disregarding the fact that the principal of the loan was £300m. Mr Chandler is said to have erred by assuming the principal was only £279.5m, and disregarding "the initial loss". In my view Mr Chandler did not make some sort of unwarranted assumption. He started from the position of the derecognised loan, because that was the value of the asset. The principal of the loan was indeed £300m, but the value as at the date of derecognition was £279.5m. When one compares the receipts from the loan at the date of redemption and applies the test in *Spanish Prospecting* one gets a profit of £20.5m. There is no "loss" to be taken into account and set against that profit because both accountants acknowledged that there was no such prior loss arising out of the assignment, even if there was a derecognition.

92. Mr Gardiner deployed various hypothetical transactions involving more arm's length deals in order to demonstrate that in this case there was no profit. He also sought to compare the tax position of GKA, and pointed up the possibility of taxing the same sum twice. In the end I was not assisted by these examples and fears. I have to look at the transaction that occurred in this case and determine whether it generated the profit alleged. If by some oddity of the overall transaction there is some sort of tax overlap then that may well be the consequence of the carefully structured tax planning in this case, which, through a series of steps which were not intended to have commercial merit in themselves, had a degree of artificiality about them anyway. I suspect that if there is some sort of double taxation then it arises because the chosen form of planning involved a scheme in which there was no allowable loss at the first stage, but that need not concern me further.

93. If I am to apply some sort of override (or "reality check", as suggested at the hearing) derived from the "fairly represents" aspect of section 84(1), then I consider that the £20.5m does indeed fairly represent a profit on the redemption of the loan. I do not see why it would not. If that has unintended consequences elsewhere as a result of its being part of a purchased scheme, those consequences, arising from those facts, do not introduce any element of unfairness in the approach.

94. In the light of that conclusion and analysis it is now necessary to revert to the question of whether there was a <u>realised</u> profit. The points arising here are much the same as those considered above.

95. I have reviewed the written evidence and the cross-examination of the experts on this point. Mr Parish's view (see above, para 80) seems to me to depend on a misdirected view of the accountancy facts. The £300m is undoubtedly received as cash, and so is capable of falling within a class of receipts that can be realised profits. It is, of course, true to say that PLC receives the amount of the principal of the loan. But it is also right to say that it receives an amount which exceeds the value of that loan as from the date part of its value was derecognised. Mr Parish's views (and Mr Gardiner's submissions to the same effect) miss that point. That difference should be treated as a profit, because that is what it really is. It is a recovery of more than the value of the loan as it was (or should have been) written in the books of the company.

96. Mr Gardiner also submitted that one can only have a realised profit, in these circumstances, if one can find receipts in excess of the £300m required to repay the principal. £300m went to repay the principal – there was no cash above that to generate a "profit". For the same reason as that just given, that seems to me to proceed on a false comparison. The amount received by PLC was an amount in excess of the value of the asset (after derecognition). That is the correct comparison, and it throws up a difference

which falls to be treated as a profit (in these circumstances). Of course, if there were further receipts then they could also be treated as realised profits (and it was accepted by PLC that the special dividend qualified in this respect), but that does not detract from the fact that the accreted amount was also a profit. That is how Mr Chandler viewed it, and although he regarded this as at least in part a legal and not an accounting question, I think he was right.

97. Putting his submissions a different way, Mr Gardiner submitted that when GKBR repaid the loan, it paid £300m. If £20.5m of that was "attributable" to the accretions in the profit and loss account then one is left with only £280m odd to repay a loan of £300m. That submission is the same false analysis. What is repaid, as a matter of law, is a principal liability of £300m. When the money is paid the liability is discharged. When the sum is written into the accounts, it reflects the realisation of £300m in respect of an asset worth only £279.5m. It is therefore appropriately recorded as yielding a profit of £20.5m over that asset value. Mr Gardiner's submission again confuses the amount of the principal of the loan with the properly recorded value of the loan as an asset – the latter being, if you like, a sort of deemed acquisition price (I use that as an analogy only). Repayment deals with the former as a matter of law. Accountancy principles, and different legal principles, deal with the effect of the latter. There is no need to find an extra £20.5m.

98. Mr Gardiner referred me to the FTT decision in *Versteegh Ltd v HMRC* [2013] UKFTT 642 (TC), which he said was instructive on this point. I am afraid I did not manage to find anything in that case which supported Mr Gardiner in this respect.

99. I therefore find that there was a "realised profit" which arose on the repayment of the loan, as maintained by HMRC.

Statutory provisions - HMRC's method and section 85(2)(c)

100. I next turn to other statutory provisions. Section 85 deals with the accounting methods that are permissible for the purpose of determining whether there are profits or gains. Subsection (1) allows an accruals basis and a mark to market basis, but the latter is not applicable to this matter. So the accruals basis is the only permitted basis. The accounts of PLC were drawn on that basis. However, subsection (2)(c) contains a constraint on applying the accruals basis. That basis, in any given case, must

> "not contain any provision (other than provision in respect of exchange losses or provision comprised in authorised arrangements for bad debt) that gives debits by reference to the

valuation at different times of any asset representing a loan relationship".

101. Mr Gardiner submits that the methodology of HMRC and of the FTT contravenes this provision. The relevant loan relationship is that between PLC and GKBR, and the method of reducing the carrying value of the loan to its net present value and subsequent incremental revaluation is expressly prohibited by subsection (2)(c).

102. The FTT made no decision on this.

103. Mr Milne's answer to this was that there was no relevant "debit" in this case. The appeals in this case are concerned with credits not debits, and there is no debit falling within the provision. All there is is a recognition that the asset within the loan relationship has been split into its two elements - capital and interest. The book value of the retained element (the capital alone) is found by reference to one of the two elements which formerly comprised the asset, but that is not the sort of thing that is within the subsection.

104. In my view Mr Milne's case is correct. I agree that "debits" means "debits". The exception in the brackets makes it clear they will be in the nature of deductions rather than additions. What is taxed in this case is credits. However, that may not be a complete answer to Mr Gardiner's points, because it might be said that there is a debit element in the overall transaction when the £300m is reduced to £279.5m in the accounts of PLC. However, such a debit (if that is what it is) is not within the paragraph. The paragraph seems principally to be guarding against periodic revaluations of an asset (plural forms of "debits" and "times" are used), in which the same asset is subjected to various valuation processes over time, and that asset is the same each time it is valued. What happened in the present case is different. An asset changed its shape and became a different asset. It changed from being a right to principal and interest to a right to principal. The inclusion of the new value as a result of derecognition is not valuing the same asset as was valued before. It is a different asset, either because it has changed its nature or because part of the asset has been parted with. When derecognition takes place it does so not because the same asset is being given a different value which it happens to have at a later time; it is because the change in nature, or size, of the asset is being acknowledged (recognised), resulting in a different valuation. The subsection does not bite on that.

105. Accordingly, section 85(2)(c) does not stand in the way of HMRC's case on this appeal. Derecognition and accretion does not fall within that provision.

106. For the sake of completeness I record that Mr Milne addressed some written submissions to the effect that HMRC's method was also compliant with section 85(2)(b) (which he said he was doing for the avoidance of doubt), but since that provision was not advanced by Mr Gardiner as a basis of the appeal I shall not deal with the point.

Statutory provisions - whether the accounting method failed to comply with various provisions of Schedule 9

107. Section 84(7) brings in the provisions of Schedule 9 when it comes to operating section 84. Section 85(3)(c) provides that proper provision for allocating payments under an accruals basis is one which (inter alia) assumes (subject to authorised arrangements for bad debt) that every amount payable under a loan relationship will be paid in full as it becomes due. Schedule 9 para 5 says that in determining credits and debits to be brought into account the assumption that a debt will be paid in full may only be departed from if the debt is a bad debt, if a doubtful debt is estimated to be bad or if a liability to pay any amount is released. Schedule 9 para 5 applies where an accruals basis is required. That applies in the present case because PLC and GKBR are connected (section 87), and sub-paragraphs 3 to 5 of that paragraph limit the cases in which the assumption of full payment can be departed from in the case of a connected company. Mr Gardiner relies on these provisions as preventing what he called the writing down of the loan to GKBR in the books of PLC. Consequentially, there should be no accretion back up to £300m.

108. In my view this argument mischaracterises the derecognition exercise that HMRC says should be carried out in relation to the loan. The provisions in question limit the circumstances in which a debt due from a connected company can or should be written down in the books of the receiving company. They operate by reinforcing the assumption that the debt will be paid in full, and allowing a departure from that assumption in only limited circumstances. However, it is a mischaracterisation to describe the process of derecognition as writing down for these purposes. Furthermore, in any event there is no departure from the assumption in a derecognition case of this nature. The underlying assumption behind the entry in the accounts is still that the debt will be paid in full. What has happened is that the present value of that debt is taken into the accounts to reflect the fact that interest is not payable to PLC any more. The assumption as to due payment remains the same. The debt is not written down as one would write down a debt which has become a bad or doubtful debt. The debt is not a bad debt at all. It has merely become less valuable as a present asset because the right to interest has been parted with.

109. Therefore this argument (on which, yet again, the FTT did not express a view) fails.

Statutory provisions - Schedule 9 paragraph 14

110. Next Mr Gardiner turned to Schedule 9 para 14 which he said applies if he had lost on all the reasoning so far. The impact of the wording of this section is fairly obscure when it is devoid of context. Mr Milne explained to me that the main intended effect (or at least a context in which it frequently operated) is one in which a borrower capitalises interest incurred in relation to a large project and treats it as a capital item going to the cost of the fixed asset which is being procured. Where that is done the interest would not normally be allowed as an item in the profit and loss account, but Mr Milne explained that paragraph 14 brought it within the profit and loss account.

111. Mr Gardiner accepted this. He sought to deploy it in the present case in the event that derecognition and accretion were held to be appropriate. It is said to work in this way:

(a) The assignment of the right to interest gave rise to an investment in subsidiaries (or its equivalent). This was what prevented the assignment giving rise to a loss.

(b) That investment would be treated as a fixed capital asset. There was no dispute on this point. The paragraph therefore bit on it as such.

(c) This would be a debit to the carrying value of that fixed capital asset. Normally that would not be a profit and loss item, but this paragraph required that it be treated as a profit and loss item for tax purposes (albeit that the accounts of the company would not show it as such).

(d) That meant it was available as a debit (in layman's terms) to be applied against the credit (in layman's terms) arising when the loan was redeemed and £20.5m was taken to profit and loss account.

112. Mr Milne's response to this was twofold. His first was one not taken in his original skeleton argument on this appeal. Indeed, I understand he did not take it below either, but Mr Gardiner did not object to its being taken on appeal. He submitted that the item in question was not one which was given "in respect of a loan relationship", so the paragraph did not apply. His second was that even if he was wrong about the first, the item arose in the course of a transaction which was carried out for an unallowable purpose within paragraph 13, and therefore should not be taken into account.

113. There was no ruling on this point in the FTT, in this case because Mr Milne's points were not taken there.

114. I must confess that I struggled to identify and understand the debit that Mr Gardiner relied on. It smacked of an artificial or contrived concept for these purposes. However, Mr Milne did not dispute its existence. Accordingly the point is therefore a short one - is this "a debit or credit … in respect of a loan relationship of [the] company"?

115. In my view Mr Milne is correct about this. The only potentially relevant loan relationship that PLC had in this respect was the relationship with GKBR. What has happened in law is that the interest has been assigned. The result in terms of derecognition is plainly something done "in respect of" that relationship. What has also happened as an effect of that transaction, though not (at least not fully) as the price of that transaction, is that the value of the investment in GKA has gone up. There is no relevant incoming consideration (apart perhaps from the £1.5m nominal value of the preference shares). Mr Chandler treated what PLC did as a capital contribution (at least in an amount over and above the fair value of the preference shares). The result is or should be reflected in the accounts of the company as such. But the manner in which it is reflected is not something which happened "in respect of [the] loan relationship" with GKBR, so it is not a credit or debit "in respect of [the] loan relationship". It is an entry in the books which reflects the consequences of the transaction that was carried out with GKA in relation to the interest; but it is not "in respect of" the loan relationship with GKBR. It has nothing to do with the loan relationship. The entry that is in respect of that relationship is the derecognition debit.

116. That means that Mr Milne's other way of dealing with the point does not arise, but the point was argued and I shall deal with it.

117. Paragraph 13 prevents the taxpayer from relying on such debits or credits as are attributable to an "unallowable purpose". Under paragraph 13(2) an unallowable purpose is one which is "not amongst the business or other commercial purposes of the company". Paragraph 13(4) deals with tax avoidance. The effect of the wording of that paragraph (reversing out the negatives), is that if tax avoidance is the main purpose, or one of the main purposes, of the transaction then it is not a business or commercial purpose of the company. If it is a less than main purpose, then it can be a commercial purpose.

118. Mr Milne submits that this paragraph applies to prevent reliance on paragraph 14 (if it could otherwise be relied on) because tax avoidance was a main purpose of the transaction. In paragraph 12 the FTT said it had "no real doubt" that "the perceived tax saving was the predominant purpose of the transactions", and in the following paragraphs provide a little material about that:

> "12. We need at this point to embark on a short digression. Mr Milne suggested to Mr Webb, by reference to various contemporaneous emails, that each of the transactions, far from being an efficient means by which PLC could continue to do what it had been doing for many years (that is, provide acquisition finance to its subsidiaries) was in truth no more than a tax saving device, one moreover in which Ernst & Young was to share, by taking a percentage of the tax saved by its adoption. It was, he said, "a scheme for making what would otherwise be taxable income vanish into thin air". We have no real doubt that the perceived tax saving was the predominant purpose of the transactions: the appellants acknowledged that they used a marketed scheme, one feature of which, as Ernst & Young's presentation to prospective clients showed, was that "it provides a borrowing company within the Group an interest deduction on its finance without the lender being taxed on this interest".
>
> 13. Mr Webb did not claim that the steps in the transactions undertaken in 2003 represented a more effective means by which PLC could provide funds for its subsidiary than a simple loan, and he accepted, even if rather reluctantly, both that the special dividends had no commercial purpose and that GKA became the vehicle for future acquisitions as an integral part of the scheme, and not for separate commercially-driven reasons. In addition Mr Clifford, in the opinion to which we shall later come, made the point that
>
> "The … transaction looked at in isolation is not on arm's length terms. No company would rationally sell a valuable future interest stream for a consideration of such little comparative value, unless it already had control of the transferee such that it could benefit indirectly from the value of the income stream."

14. However, HMRC have not hitherto advanced arguments that the transactions fail in their purpose for these reasons. At para 5 of the statement of case they say:

"The object of the scheme was to achieve the position whereby a debit is generated in GKBR in respect of the payment of the interest flow to GKA, whereas no corresponding credits would be imputed to GKA (as recipient) or PLC (as assignee)."

15. This paragraph encapsulates the thrust of HMRC's case about the intended result of the arrangements, namely that one group company receives tax relief on payments it makes to another group company, while the recipient is not charged to tax on the receipt. As we have indicated, that is precisely what Ernst & Young offered when presenting the scheme to prospective clients. Mr Milne put it in this way in his skeleton argument:

"[The] transactions were structured in the curious way they were (considering that GKA could have been funded to make its acquisitions by simple interest-free loan) in order to attempt to take advantage of a perceived loophole in the loan relationships legislation so as to achieve a tax mismatch within the Greene King group. If the scheme were to succeed, GKBR would be entitled to a deduction (for corporation tax purposes) of over £21m for interest paid on an intergroup loan, without any company in the group being chargeable on the corresponding receipt."

16. The statement of case goes on to argue, however, that the arrangement does not succeed in that purpose, not because it is an abuse, or falls foul of anti-avoidance provisions, but because it does not, as a matter of law and accounting practice, have the intended result. The same approach was adopted in the correspondence which led to the disputed notices of amendment (even though the transactions were described by HMRC in that correspondence as "artificial") and, despite the extract we have set out, in Mr Milne's skeleton argument. In those circumstances we do not think it necessary or appropriate to dwell further on the appellants' motives, nor to consider whether or not the transactions were abusive. Nevertheless, the admitted purpose of the transactions is not a factor which can be ignored entirely. It was of

> particular importance in relation to Mr Clifford's role, to which we shall come later."

119. As is apparent from paragraph 16, the tax avoidance point was not one that was actually taken by HMRC before the FTT in relation to Schedule 9 paragraph 14. Mr Gardiner takes that point, and submits that it is not now open to HMRC to run it on the appeal by taking advantage of the "short digression" of the FTT. He relies on *Mullarkey v Broad* [2009] EWCA Civ 2 as preventing the point being taken on appeal, and submits that since the motivation of PLC was not in issue it did not put in evidence, or give disclosure, going to it. PLC would be seriously and wrongly prejudiced if the Revenue were now allowed to take advantage of the observations of the FTT in relation to a point that was never run as a point below.

120. I agree with Mr Gardiner that HMRC cannot take this point now. The place of a tax avoidance motivation in the transaction in question is a question of fact, and if the point is to be taken then it must be clearly flagged so that the taxpayer can address it. That did not happen in this case. The FTT acknowledges as much in its paragraph 14. Mr Milne accepted that the point was not pleaded as such, and the only cross-examination on the point to which I have been referred demonstrates that questions were asked about the special dividend and the witness acknowledged that it was part of "tax efficient funding". So the point was not even properly canvassed in cross-examination. Against that background HMRC cannot take the point now. It was a point for them to flag and allege, so that PLC could then meet it with appropriate evidence. The point would have had to have been tested in cross-examination. None of that happened. It is not open to HMRC to seize on the observations of the FTT to which I have referred and to seek to build this new case on those observations. Mr Milne said there was lots of evidence which showed it was "blindingly obvious" that the motivation, or main motivation, of the scheme was tax avoidance. If that is right then it is surprising that HMRC did not take the point clearly. But whether it is right or not, all requirements for the fair conduct of disputes require that HMRC be not allowed to take this point for the first time in this appeal. I therefore reject Mr Milne's case on the point.

121. HMRC nevertheless succeeds on the disapplication of Schedule 9 paragraph 14 for the reasons given in the first half of this section of this judgment.

Conclusion in Issue 2

122. In relation to Issue 2, for the reasons appearing above Mr Gardiner has not succeeded in demonstrating that the FTT's conclusion on that issue was wrong and I therefore dismiss the appeal.

Issue 3

123. This issue relates to the existence of a loan relationship between GKA and GKBR. The issue that the parties identified, and argued, was:

> "Whether GKA has a loan relationship with GKBR as a result of the first transaction."

124. In its judgment the FTT expressed the view that there was no need to answer that issue as formulated "for its own sake", and went on:

> "The real question is a little more complicated, and is whether the interest received by GKA following the strip arises from a loan relationship of GKA. We do, however, need to address the nature of a loan relationship in order to provide an answer."

125. The FTT then went on to consider the submissions of the parties and decided the point in the negative. It accepted the argument of the Revenue. Its own conclusion contrasted the position of GKA with an original lender and also with an assignee of a loan from a lender. In the present case GKA did not stand in PLC's shoes and had no right to payment of the capital sum. The creditor remained PLC, which chose to require GKBR to pay the interest due to GKA. It went on:

> "Plainly the loan relationship between PLC and GKBR subsisted, and we agree with Mr Milne that the interest arose from *that* loan relationship. Thus even if there was a loan relationship between GKA and GKBR (and it is unnecessary for us to decide the point), the interest did not arise under it. Mr Milne is consequently right to argue that the sums received by GKA did not fall within s84(1)(b); the requirement that interest should arise under *GKA's* loan relationships is not met." (The emphasis is the FTT's).

And it concludes:

> "Issue 3. We do not determine this issue in quite the manner in which it is set out above. Whether or not GKA had a loan relationship with GKBR, which we do not need to decide, the payments by GKA did not arise from that relationship and did not fall within s84(1)(b)."

126. Mr Gardiner's submission was that this analysis was wrong. He argued that both section 81 elements necessary to create a loan relationship were present - GKA became a creditor of GKBR, and the relevant debt arose from a transaction for the lending of money albeit that the lending was between PLC and GKBR. He asserted that before the FTT HMRC appeared to accept that there was a loan relationship, and once that is accepted it follows that the profits arising from it fall to be taxed under the loan relationship regime, and only under that regime. I should observe at this point that his cross-reference to the argument below was misplaced - HMRC did not seem to accept that there was a loan relationship, but advanced an "even if there was" argument. However, as will appear, on this appeal Mr Milne did accept that there was a loan relationship, albeit that he did not analyse it as Mr Gardiner did.

127. Mr Gardiner went on to argue that the payments received by GKA were (from its perspective) not payments of interest, because they were merely payments of a debt. The only profit that fell to be recognised as such in GKA's accounts (and thus taxed as profit) was the increase in value of the moneys received over the moneys paid for the right to receive the interest (in this case about £768,000). GKA could not be charged to tax under the loan relationship provisions on the whole value of the interest strip acquired, because the initial value of the loan relationship could not constitute a profit or gain from the loan relationship or a related transaction under section 84(1). In normal tax terms, there was no profit or gain when the value of the interest strip was received because there is no profit or gain merely on receipt of an asset. Furthermore, the receipt of the sums paid by GKBR as interest could not be charged as interest in GKA's hands because it had lost its character as interest (at least as far as GKA is concerned) on the assignment.

128. Mr Milne's skeleton argument adopted the reasoning of the FTT (not surprisingly, since save in respect of one particular authority, the FTT described itself as accepting Mr Milne's arguments below). It did not expressly accept or disavow the existence of some loan relationship, and took the point that the sums payable after the assignment were payable pursuant to a loan relationship other than any such relationship that GKA might have. However, in argument before me Mr Milne did unequivocally accept that GKA did have a loan relationship involving the GKA moneys. His analysis was that as and when each instalment of the interest payable by GKBR became due a separate loan relationship arose in relation to that money. However, that money was not interest paid under such a loan relationship. It was technically a debt. The only interest that might (theoretically) have arisen under that loan relationship was such interest as might be payable on the late payment of the GKBR interest instalment, though as it happens none of those payments were ever late. Since there were 4 payments due, there were 4 loan relationships. However, he made it clear that the payments did not represent a "profit or gain" to GKA under any loan relationship. HMRC contended that those moneys were taxable as schedule D profits on a different basis.

129. The debate on this issue has adopted a flexible form. The issue that was formulated for the FTT confined itself to the question of whether there was any loan relationship. That could have been answered Yes or No, but no doubt in coming to such a conclusion the FTT would have had to consider the nature of the relationship between GKA and GKBR and made some findings about that. It would not, however, have led to a determination by the FTT of the tax payable as a result of that finding. The issue was formulated in a way that would not have achieved that result. The FTT seemed to think that that was not useful enough, and so it reformulated the issue into the form described above - whether the sums received by GKA "arose from" a loan relationship of GKA. Unfortunately I do not think that that is a useful formulation either, because it would still not address the character of the payments for tax purposes. If the answer to the question is No, then one has to go on to consider whether some other tax regime is appropriate. If the answer is Yes, one still has to consider what the proper tax treatment is under the loan relationship. I can illustrate that by considering the question in the light of Mr Milne's acceptance of the existence of 4 loan relationships in the course of the payment period. If that position is correct it seems to me to be inevitable that the answer to the question "Was there a loan relationship" would be Yes, and an answer to the question "Did those payments arise from that loan relationship" would also be Yes. But the parties would be no further on because all the important tax questions would still have to be addressed, which would require a further analysis of just what the relationship was and how the "interest" instalments fell within the taxation regime.

130. The debate before me did indeed go further than providing a simple Yes/No answer to the question, because both parties made submissions as to the correct tax treatment once the question was answered. Mr Gardiner submitted that there was a loan relationship, and that that precluded the taxation of the receipts, in the hands of GKA, as interest because they were a payment of principal, not interest. No other part of the taxation regime could be looked to as a basis of charge because they were all excluded by the exclusivity of the loan relationship regime. Mr Milne submitted that despite the fact that there was a loan relationship (or a series of loan relationships) these sums were taxable under Schedule D case VI.

131. This is not a satisfactory state of affairs. The argument as to the actual taxation consequences of the situation go beyond the issues apparently placed before the FTT, beyond the question which the FTT decided to answer, and beyond the answer which the FTT gave (which was a simple answer to the question that it asked itself, and which did not extend into the taxation consequences of the answer). While taxation consequences will ultimately have to be considered, I do not consider that on this appeal I had all the material that I needed to decide that point, and since it was not determined by the FTT either I shall not consider it.

132. I shall therefore confine myself to the question that the FTT asked and answered. In the light of the summary appearing above, and particularly in the light of the concession made by Mr Milne, it might be thought that that is an easy task, because the answer to the question ought to be Yes, more or less automatically. However, as will appear, I do not think that Mr Milne's concession was correctly made, and I do not agree with Mr Gardiner's analysis either, so I will have to embark on a consideration of the point.

133. I remind myself of the statutory definition in section 81(1):

> "(1) Subject to the following provisions of this section, a company has a loan relationship for the purposes of the Corporation Tax Acts wherever—
>
> (*a*) the company stands (whether by reference to a security or otherwise) in the position of a creditor or debtor as respects any money debt; and
>
> (*b*) that debt is one arising from a transaction for the lending of money;

and references to a loan relationship and to a company's being a party to a loan relationship shall be construed accordingly."

With that in mind I turn to the respective contentions of the parties.

134. First, I do not consider that Mr Milne's logic can be correct. As I have observed, he submitted that Mr Gardiner was not right in his analysis of the loan relationship but accepted that there was one each time an interest instalment came due, in respect of that instalment. His reasoning was that at that point there was a debtor-creditor relationship. However, he asserted that the loan relationship in respect of the original loan remained one between PLC and GKBR. Notwithstanding that, a different loan relationship arose when the debt actually became due.

135. It seems to me that that reasoning is flawed. It assumes two things, both of which are wrong. First, it assumes that the debt, or more precisely the positions of GKA as a creditor and GKBR as a debtor (to use the terminology of section 81(1)(a)) only come into existence on the date the interest payment falls due. That is wrong. The debt and the relationship exist at all times. The debt will be payable in the future (before its due date), but in normal parlance it is still a debt. In a normal borrowing situation the principal of a term loan will be payable in the future, but it is still a debt (and must give rise to the debtor and creditor positions referred to in section 81). So if there is a relevant debt it was owing to GKA <u>at all times</u> after the assignment. Second, Mr Milne did not address how section 81(1)(b) operates in those circumstances. He seems to have assumed that the debt arose from a transaction for the lending of money without explaining how. As

between GKA and GKBR there was no such transaction, so that paragraph cannot have been satisfied in that way. As between PLC and GKBR there certainly was that relationship, but Mr Milne disclaimed that as being a relevant relationship for these purposes. So the second limb of the subsection defining loan relationships was not fulfilled, on Mr Milne's analysis. His analysis therefore fails.

136. Nonetheless Mr Milne disputed Mr Gardiner's analysis, so I have to turn to that. Mr Milne has one dictum on his side. In *Revenue and Customs Commissioners v Bank of Ireland* [2008] EWCA 58 Lawrence Collin said:

> "47. Receipt, of itself, is not a determinant of any possible tax liability. An assignee of the right to receive interest (without assignment of the loan relationship) would not be taxable on the amount of that interest under the loan relationship provisions because he has no relevant loan relationship."

137. Mr Milne relied on this statement as reflecting the law, and he pointed out that the statement was apparently adopted as part of the reasoning in *Versteegh Ltd v HMRC* [2013] UKFTT 642 (TC) at paragraphs 112 and 132, or at least it was accepted there without any suggestion of a challenge. Mr Gardiner sought to challenge Mr Milne's reliance on this statement not so much by saying that the statement was wrong, but by saying that the case as a whole (including the first instance decision of Henderson J [2007] EWHC 941 (Ch)) supported his case that the sums received by GKA were not taxable in the hands of GKA because (amongst other things) there was no source; the concept of source was said to be an important part of the reasoning of both courts in *Versteegh*.

138. The statement of Lawrence Collins LJ is clear and apparently directly in point. However, it does not seem to me that it was actually part of his reasoning in the case, and as such it is not binding. It contains no reasoning, and (though the fault may be mine) I had a little difficulty in understanding its position in his line of argument. It was made in the context of a passage dealing with source, which is a different point. The FTT stated that it was not assisted by the statement because the legislative provisions in issue in the *Bank of Ireland* case were different and it did not consider the statement binding, and I agree with the latter point. Since it is not binding, and since the point arises directly for decision on this appeal I have to consider the point myself in more depth.

139. It seems to me that one cannot properly consider whether money "arose from" a loan relationship (to use the FTT's terminology) without first defining that relationship (if

any), so that, logically, is the first question that has to be tackled. The FTT's approach is not wholly satisfactory because it was prepared to assume that there was a loan relationship and says that even if there was one the moneys were not paid pursuant to that relationship (whatever it is) because it was paid pursuant to <u>another</u> relationship (the loan relationship between PLC and GKBR). That is not a satisfactory process of analysis because it ignores the possibility of a loan relationship existing between GKA and GKBR which is of a nature which would enable (or even oblige) one to say that the payments were made pursuant to that relationship as well (as a matter of statutory interpretation and legal analysis).

140. The language of section 81, by itself, would seem to favour Mr Gardiner's case. There is a debtor/creditor relationship in respect of a money debt (subs 1(a)) and, on a literal level, it arises from a transaction for the lending of money (subs (1)(b)), because it arises from the lending of money by PLC to GKBR. However, I do not think a literal interpretation is necessarily appropriate to a section which has some underlying purpose. The underlying concept is a "loan relationship", and while that is carefully defined one must give appropriate effect to the words used, which demonstrate a requirement to investigate a "relationship". The relationship between GKA and GKBR is one which involves a debt, but as a relationship it does not, in any meaningful sense, involve a transaction for the lending of money as between the two of them. It is one in which a periodic payment is due but that payment does not, as between the two of them (and therefore within their relationship) any longer arise from a transaction for the lending of money. One can distinguish this from an assignment of principal together with the interest. The assignment of the right to principal means that as between the debtor and the assignee, and within the relationship, the debt does arise from a transaction which can properly be viewed as one for the lending of money, albeit that the lending did not originally take place as between the two parties. The relationship remains one which is fair to characterise as involving a transaction for the lending of money for the purposes of the subsection. The same applies to an assignment of part of the principal and interest.

141. This may have been the thinking behind the statement of Lawrence Collins LJ in *Bank of Ireland*. His words in brackets ("without assignment of the loan relationship") suggest a focus on the relationship as a concept. Something that destroys the original nature of the relationship by separating principal from interest completely destroys any notion of a loan <u>relationship</u>. Another way of looking at the matter is to say that while the interest originally "[arose] from a transaction for the lending of money", once the interest is completely divorced from the principal it no longer has that character <u>as between the assignee and the borrower</u>. It can be said to have, or retain, that character, while it is accompanied by the principal, but not once there is no connection.

142. In support of his proposition that an assignment of interest without the principal can give rise to a loan relationship between the assignee and the lender Mr Gardiner pointed to section 95 of the Act. That section deals with "gilt strips", and he said that it demonstrated that the legislation pre-supposed that such a thing, which he described as being the same as an assignment of interest, brought about a loan relationship between the new holder of the strip and (I suppose) the government. He did not say that the section clearly said so; his submission was that the section assumed so.

143. I do not think that this section assists Mr Gardiner. He described a "gilt strip" in simple terms involving a separation of interest and passing the interest to an assignee. That is too simple an analysis. The meaning of "gilt strip" for the purposes of the section is the same as the meaning given to it in section 42 of the Finance Act 1942 (see section 95(7)). That provides the following definition in subs (1B):

> "(1B)In this section "strip", in relation to any stock or bond, means a security issued under the National Loans Act 1968 which—
>
> (a) is issued for the purpose of representing the right to, or of securing—
>
> (i) a payment corresponding to a payment of interest or principal remaining to be made under the stock or bond, or
>
> (ii) two or more payments each corresponding to a different payment remaining to be so made;
>
> (b) is issued in conjunction with the issue of one or more other securities which, together with that security, represent the right to, or secure, payments corresponding to every payment remaining to be made under the stock or bond; and
>
> (c) is not itself a security that represents the right to, or secures, payments corresponding to a part of every payment so remaining."

144. So far as that provision is intelligible, it seems to be describing an arrangement in which there is a form of direct creation of a new obligation, and an issue of a security in respect of it, and not a straight assignment of an existing obligation. That is borne out by paragraphs CFM37150 and CFM37160 of HMRC's Corporate Finance Manual, which describes such a process. What section 95 does is to deal with the taxation/valuation aspects of that activity. It deals with it both in the context of the creation of a gilt strip and in the context of a sort of reversal of that process into a single gilt (see subs (3)). It is not dealing with an assignment of the right to interest - see subs (2) which refers to "exchange". There did not seem to be a dispute that the holder of a gilt is in a loan relationship, and the matters with which section 95 deals are all capable of being relevant to that relationship, but that is as far as it goes. Accordingly, section 95 does not assist Mr Gardiner because it does not embody the assumption he relies on.

145. I therefore find that in the present case there was no loan relationship at all. This means that the answer that the FTT gave to its version of Question 3 stands, but not for the reason that it gave. The answer to the original Question 3 is "No". The appeal on this point is therefore dismissed.

Issue 4

146. This issue, and the appeal on it, only arises if GKA and GKBR have a "loan relationship". I have held that they do not, so the point becomes academic. However, I received submissions on it and I will make certain remarks about it.

147. The point affects moneys in the hands of GKA, not PLC. It relates to the treatment of the fruits of the assignment of the interest in the hands of that company. As formulated, the issue was:

> "Whether s 84(2)(a) applies to the credits in GKA's accounts arising from the receipt of interest."

148. The FTT answered this question in different terms:

> "Issue 4: Section 130 of the Companies Act 1985 did not require GKA to transfer the premium received on the issue of the preference shares to its share premium account. Moreover, s 84(2)(a) does not apply to the payments received by GKA.

> Alternatively, it applies only an amount [sic] equivalent to the minimum premium value."

149. The issue arises in this way. Section 84(2)(a) provides that profits, gains and losses referred to in subs (1) do not include:

> "a reference to any amounts required to be transferred to the company's share premium account."

In order to ascertain what, if anything, has to be transferred to share premium account one looks to section 130 of the Companies Act 1985 (see the Appendix), which requires certain amounts to be paid to the credit of a company's share premium account but subject to exceptions contained in, inter alia, section 132. Section 132 operates in the situation of a holding/subsidiary company transaction. Its effect is to require, in certain circumstances, the transfer of only the "minimum premium value", as defined (the definition does not appear in the Appendix because its precise terms do not matter). Thus the lower the minimum premium value, the lower the amount that has to be credited to share premium account and the greater the amount that falls to be treated as profit, gain or loss; and vice versa. It was therefore in the interests of GKA to have a high minimum premium value so as to justify a high credit to share premium account (assuming section 132 to have any application).

150. GKA relies on these provisions as requiring the transfer of £19m to share premium account, with the effect that that amount does not fall into computation of tax. All that would fall to be taxed as profits is the excess of recoveries from GKBR over the value of the amount received. If there is a loan relationship GKA is taxed on the credits to its accounts in respect of that loan relationship, and the credit to share premium account was removed as a relevant credit by virtue of section 84(2)(a) and section 130. GKA contends that section 132 had no application on its true construction.

151. The Revenue started from a different point. It submitted that the relevant credit was the receipt of moneys by GKA over the period of the payment, not an initial credit, so section 84(2)(a) had nothing to do with it. However, if that was wrong and one had to look to the share premium account provisions of the Companies Act, the Revenue accepted that unless section 132 applied to this case, then the relevant premium ought indeed to be credited in full to share premium account. However, it also said that section 132(1) did indeed apply, so that the application of section 130 was modified accordingly. Only the minimum premium value ought to be transferred to share premium account. If there was no derecognition then the minimum premium value was zero, with the effect that nothing

fell to be credited to share premium account; but the Revenue also accepted that if there was derecognition in the amount claimed then the minimum premium value was the amount of derecognition, with the result that section 84(2)(a) would operate as GKA said it should operate.

152. The FTT's Decision summarised the arguments before it, and then accepted

> "Mr Milne's first argument … - s130 can have no application to the receipts from GKBR. But even in that is wrong, we also agree with him that s 132 limits the obligation to effect a transfer to GKA's share premium account."

153. It then went on to give reasons for its conclusions about section 132, dismissing GKA's arguments that the subsection was intended to deal with reconstructions only, and that multiple "assets" were contemplated by the section, not just one asset. Paragraph 93 of the Decision ended:

> "Our conclusion on this issue, therefore, is that s 84(2)(a) does not apply to the receipts in full or, if we are wrong in our first conclusion on this issue, applies only to an amount equal to the minimum premium value."

154. It did not express a view as to what the minimum premium value was, stating that it was "essentially a mathematical argument". When it came to express a conclusion on the formulated issue at the end of the Decision the FTT expressed itself in the terms set out above.

155. On the appeal before me there was something of a mis-match in the submissions. Mr Milne's first submission (logically, though not always in terms of order of presentation) was the one recorded as having been made first to the FTT, namely that section 84(2)(a) did not catch the receipts that were relevant in this case because the relevant receipts for tax purposes were actual receipts of moneys from GKBR when the interest fell due and was paid. The crediting of those receipts did not raise any question of credits to share premium account. That seems to me to be right, if "credits in GKA's accounts arising from the receipt of interest" in Issue 4 meant "receipts" in that sense. Whether answering the question in those terms does any useful work in answering the real tax questions in this case I rather doubt.

156. Mr Gardiner's submissions seemed to assume that Issue 4 was about something else - the effect of section 130 on the occasion of the acquisition of the interest strip and the issue of the shares. The Revenue accepted that section 130 would have the effect of requiring about £20m to be credited to share premium account unless section 132 applied, but said that section 132 did indeed apply. The debate therefore focussed around the applicability of that latter section.

157. Mr Gardiner's submissions were that the subsection did not apply for the following reasons:

(i) It only applied to "reconstructions", and this situation was not one.
(ii) It only applies to consideration which consists of "assets" (in the plural) "other than cash" (subs (1)(b)), and in the present case there was just one "asset" (in the singular) and it consisted of cash.

158. So far as Mr Gardiner's first submission is concerned, it has its roots in the heading to section 132 - "Relief in respect of group reconstructions". Even allowing for the fact that one can give some effect to headings, Mr Gardiner's submissions give the heading far too much weight. The words used in the body of the section are clear and are not confined to the sort of reconstruction that Mr Gardiner had in mind. Those words contain the qualifications for the relief. If GKA comes within them, it does not matter whether the transaction can or cannot be called a "reconstruction".

159. On the first limb of his second submission ("assets") the FTT held that the ordinary canons of statutory construction required that the plural be construed as including the singular. I agree. The Interpretation Act 1978 section 6 so provides, and in any event it would be illogical and irrational to disapply section 132 where there is only one asset transferred and apply it only where there were two or more. Parliament should not have such irrationality attributed to it.

160. The second limb depends on whether the rights assigned by PLC to GKA amounted to "cash" or "assets other than cash". Mr Gardiner said they should be treated as the former, with the result that section 132 did not apply. I disagree. In normal parlance the benefit of a debt cannot be regarded as cash. Cash arises when the debt is paid, but not until then. It might be turnable into cash, but then so are most assets. Its nature might be such that its realisation would inevitably result in cash, but then so would physical stock. None of that makes it "cash". I also find that the expression "in consideration for the transfer … of assets other than cash" means the provision of something like cash by the provider of the consideration (here, PLC). All that PLC provided was the benefit of a debt, not cash, and that does not amount to cash (money) provided by PLC - see *System Control plc v Munro Corporate plc* [1990] BCLC 659 at p662g (Hoffman J), albeit a

decision on a different statutory provision. As Mr Milne pointed out, Mr Gardiner expressly did not press this point hard, and did not take me to authorities that he had available, and in my view he was right not to do so.

161. That means that section 132 would operate to temper the effect of section 130. Only the "minimum premium value" fell to be credited to share premium account. However, as has already appeared, on the footing that derecognition in PLC ought to have taken place, the Revenue considers that (in substance) the minimum premium value is the same number that has already been credited. This means that, for the purposes of section 130, the amount to be credited to share premium account would, after all, be the amount actually credited, so it turns out that this debate does not matter much.

162. I therefore summarise the position on Issue 4 as follows, on the assumption that the relevant credits are those arising out of the occasion of the acquisition of the debt by GKA:

i) Section 84(2)(a) does not apply because there is no relevant loan relationship

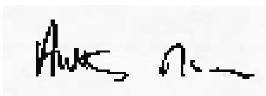
ii) If it did apply, section 132 would apply to limit the amount to be credited to the minimum premium value

iii) If the minimum premium value is relevant then in the light of my findings on the derecognition point, the Revenue accepts that that value is at least the £19.5m taken to share premium account by GKA, so GKA is correct in what it did on that hypothesis.

163. The answer to Issue 4, in the terms of that issue, is therefore No, and the appeal on this point fails too.

Conclusion

164. I therefore dismiss the appeal. I will receive submissions on consequential matters in the normal way.



UPPER TRIBUNAL JUDGE: MR JUSTICE MANN

RELEASE DATE: 22 April 2014

Appendix - legislation

<u>Companies Act 1985</u>

130 Application of share premiums

"(1) If a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account called 'the share premium account'.…

(4) Sections 131 and 132 below give relief from the requirements of this section, and in those sections references to the issuing company are to the company issuing shares as above mentioned."

132 Relief in respect of group reconstructions

(1) This section applies where the issuing company—

(a) is a wholly-owned subsidiary of another company ('the holding company'), and

(b) allots shares to the holding company or to another wholly-owned subsidiary of the holding company in consideration for the transfer to the issuing company of assets other than cash, being assets of any company ('the transferor company') which is a member of the group of companies which comprises the holding company and all its wholly owned subsidiaries.

(2) Where the shares in the issuing company allotted in consideration for the transfer are issued at a premium, the issuing company is not required by section 130 to transfer any amount in excess of the minimum premium value to the share premium account."

[The following subsections define minimum premium value - it is unnecessary to set them out here.]

<u>Finance Act 1996</u>

80 Taxation of 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.

(2) To the extent that a company is a party to a loan relationship for the purposes of a trade carried on by the company, profits and gains arising from the relationship shall be brought into account in computing the [profits][1] of the trade.

(3) Profits and gains arising from a loan relationship of a company that are not brought into account under subsection (2) above shall be brought into account as profits and gains chargeable to tax under Case III of Schedule D.

…

(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.

81 Meaning of "loan relationship" etc

(1) Subject to the following provisions of this section, a company has a loan relationship for the purposes of the Corporation Tax Acts wherever—

(*a*) the company stands (whether by reference to a security or otherwise) in the position of a creditor or debtor as respects any money debt; and

(*b*) that debt is one arising from a transaction for the lending of money;

and references to a loan relationship and to a company's being a party to a loan relationship shall be construed accordingly.

(2) For the purposes of this Chapter a money debt is a debt which is, or has at any time been, one that falls, or that may at the option of the debtor or of the creditor fall, to be settled—

(*a*) by the payment of money; or

(*b*) by the transfer of a right to settlement under a debt which is itself a money debt

disregarding any other option exercisable by either party.

(3) Subject to subsection (4) below, where an instrument is issued by any person for the purpose of representing security for, or the rights of a creditor in respect of, any money debt, then (whatever the circumstances of the issue of the instrument) that debt shall be taken for the purposes of this Chapter to be a debt arising from a transaction for the lending of money.

(4) For the purposes of this Chapter a debt shall not be taken to arise from a transaction for the lending of money to the extent that it is a debt arising from rights conferred by shares in a company.

(5) For the purposes of this Chapter—

(*a*) references to payments or interest under a loan relationship are references to payments or interest made or payable in pursuance of any of the rights or liabilities under that relationship; and

(*b*) references to rights or liabilities under a loan relationship are references to any of the rights or liabilities under the agreement or arrangements by virtue of which that relationship subsists;

and those rights or liabilities shall be taken to include the rights or liabilities attached to any security which, being a security issued in relation to the money debt in question, is a security representing that relationship.

(6) In this Chapter "money" includes money expressed in a currency other than sterling.

82 Method of bringing amounts into account

(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.

(2) To the extent that, in any accounting period, a loan relationship of a company is one to which it is a party for the purposes of a trade carried on by it, the credits and debits given in respect of that relationship for that period shall be treated (according to whether they are credits or debits) either—

(*a*) as receipts of that trade falling to be brought into account in computing the [profits][1] of that trade for that period; or

(*b*) as expenses of that trade which are deductible in computing those [profits][1].

(3) Where for any accounting period there are, in respect of the loan relationships of a company, both—

(*a*) credits that are not brought into account under subsection (2) above ("non-trading credits"), and

(*b*) debits that are not so brought into account ("non-trading debits"),

the aggregate of the non-trading debits shall be subtracted from the aggregate of the non-trading credits to give the amount to be brought into account under subsection (4) below.

…

84 Debits and credits brought into account

(1) 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, in accordance with an authorised accounting method 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.

(2) The reference in subsection (1) above to the profits, gains and losses arising to a company—

(a) does not include a reference to any amounts required to be transferred to the company's share premium account; but

(b) does include a reference to any profits, gains or losses which, in accordance with generally accepted accounting practice, are carried to or sustained by any other reserve maintained by the company.

…

(7) This section has effect subject to Schedule 9 to this Act (which contains provision disallowing certain debits and credits for the purposes of this Chapter and making assumptions about how an authorised accounting method is to be applied in certain cases).

85 Authorised accounting methods

(1) Subject to the following provisions of this Chapter, the alternative accounting methods that are authorised for the purposes of this Chapter are—

(a) an accruals basis of accounting; and

(b) a mark to market basis of accounting under which any loan relationship to which that basis is applied is brought into account in each accounting period at a fair value.

(2) An accounting method applied in any case shall be treated as authorised for the purposes of this Chapter only if—

(a) subject to paragraphs (b) to (c) below, it is in conformity with generally accepted accounting practice to use that method in that case;

(b) it contains proper provision for allocating payments under a loan relationship, or arising as a result of a related transaction, to accounting periods;

(bb) it contains proper provision for determining exchange gains and losses from loan relationships for accounting periods; and

(c) where it is an accruals basis of accounting, it does not contain any provision (other than provision in respect of exchange losses or provision comprised in authorised arrangements for bad debt) that gives debits by reference to the valuation at different times of any asset representing a loan relationship.

(3) In the case of an accruals basis of accounting, proper provision for allocating payments under a loan relationship to accounting periods is provision which—

(a) allocates payments to the period to which they relate, without regard to the periods in which they are made or received or in which they become due and payable;

(b) includes provision which, where payments relate to two or more periods, apportions them on a just and reasonable basis between the different periods;

(c) assumes, subject to authorised arrangements for bad debt, that, so far as any company in the position of a creditor is concerned, every amount payable under the relationship will be paid in full as it becomes due;

(d) secures the making of the adjustments required in the case of the relationship by authorised arrangements for bad debt; and

(e) provides, subject to authorised arrangements for bad debt and for writing off government investments, that, where there is a release of any liability under the relationship, the appropriate amount in respect of the release is credited to the debtor in the accounting period in which the release takes place.

…

(5) In this section

(a) the references to authorised arrangements for bad debt are references to accounting arrangements under which debits and credits are brought into account in conformity with the provisions of paragraph 5 of Schedule 9 to this Act; and

(b) the reference to authorised arrangements for writing off government investments is a reference to accounting arrangements that give effect to paragraph 7 of that Schedule.

…

86 Application of accounting methods

(1) This section has effect, subject to the following provisions of this Chapter, for the determination of which of the alternative authorised accounting methods that are available by virtue of section 85 above is to be used as respects the loan relationships of a company.

(2) Different methods may be used as respects different relationships or, as respects the same relationship, for different accounting periods or for different parts of the same accounting period.

(3) If a basis of accounting which is or equates with an authorised accounting method is used as respects any loan relationship of a company in a company's statutory accounts, then the method which is to be used for the purposes of this Chapter as respects that relationship for the accounting period, or part of a period, for which that basis is used in those accounts shall be—

(a) where the basis used in those accounts is an authorised accounting method, that method; and

(b) where it is not, the authorised accounting method with which it equates

but this subsection is subject to subsections (3A) and (3D) below.

…

(4) For any period or part of a period for which the authorised accounting method to be used as respects a loan relationship of a company is not—

[(a) a method determined under subsection (3) above,

(b) an authorised mark to market method in accordance with an election under subsection (3A) above, or

(c) an authorised mark to market method in accordance with subsection (3D) above,

an authorised accruals basis of accounting shall be used for the purposes of this Chapter as respects that loan relationship.

(5) For the purposes of this section (but subject to subsection (6) below)—

(a) a basis of accounting equates with an authorised accruals basis of accounting if it purports to allocate payments under a loan relationship to accounting periods according to when they are taken to accrue; and

(b) a basis of accounting equates with an authorised mark to market basis of accounting if (without equating with an authorised accruals basis of accounting) it purports in respect of a loan relationship

(i) to produce credits or debits computed by reference to the determination, as at different times in an accounting period, of a fair value; and

(ii) to produce credits or debits relating to payments under that relationship according to when they become due and payable.

87 Accounting method where parties have a connection.

(1) This section applies in the case of a loan relationship of a company where for any accounting period there is a connection between the company and—

(*a*) in the case of a debtor relationship of the company, a person standing in the position of a creditor as respects the debt in question; or

(*b*) in the case of a creditor relationship of the company, a person standing in the position of a debtor as respects that debt.

(2) The only accounting method authorised for the purposes of this Chapter for use by the company as respects the loan relationship shall be an authorised accruals basis of accounting.

(3) For the purposes of this section there is a connection between a company and another person for an accounting period if (subject to subsection (4) and section 88 below)—

(*a*) the other person is a company and there is a time in that period [...] when one of the companies has had control of the other; or

(*b*) the other person is a company and there is a time in that period [...] when both the companies have been under the control of the same person; [...]

…

(5) The references in subsection (1) above to a person who stands in the position of a creditor or debtor as respects a loan relationship include references to a person who indirectly stands in that position by reference to a series of loan relationships or money debts which would be loan relationships if a company directly stood in the position of creditor or debtor.

…

95 Gilt strips

(1) This section has effect for the purposes of the application of an authorised accruals basis of accounting as respects a loan relationship represented by a gilt-edged security or a strip of a gilt-edged security.

(2) Where a gilt-edged security is exchanged by any person for strips of that security—

(*a*) the security shall be deemed to have been redeemed at the time of the exchange by the payment to that person of its market value; and

(*b*) that person shall be deemed to have acquired each strip for the amount which bears the same proportion to that market value as is borne by the market value of the strip to the aggregate of the market values of all the strips received in exchange for the security.

(3) Where strips of a gilt-edged security are consolidated into a single gilt-edged security by being exchanged by any person for that security—

(*a*) each of the strips shall be deemed to have been redeemed at the time of the exchange by the payment to that person of the amount equal to its market value; and

(*b*) that person shall be deemed to have acquired the security received in the exchange for the amount equal to the aggregate of the market values of the strips given in exchange for the security.

(4) References in this section to the market value of a security given or received in exchange for another are references to its market value at the time of the exchange.

(5) Without prejudice to the generality of any power conferred by section 202 below, the Treasury may by regulations make provision for the purposes of this section as to the manner of determining the market value at any time of any gilt-edged security (including any strip).

(6) Regulations under subsection (5) above may—

(*a*) make different provision for different cases; and

(*b*) contain such incidental, supplemental, consequential and transitional provision as the Treasury may think fit.

(7) In this section "strip" means anything which, within the meaning of section 47 of the Finance Act 1942, is a strip of a gilt-edged security.

Schedule 9 LOAN RELATIONSHIPS: SPECIAL COMPUTATIONAL PROVISIONS

Bad debt etc

5**.** (1)In determining the credits and debits to be brought into account in accordance with an accruals basis of accounting, a departure from the assumption in the case of the creditor relationships of a company that every amount payable under those relationships will be paid in full as it becomes due shall be allowed (subject to paragraph 6 below) to the extent only that—

(a) a debt is a bad debt;

(b) a doubtful debt is estimated to be bad; or

(c) a liability to pay any amount is released.

(1A)Such a departure shall be made only where the first and second conditions (set out in sub-paragraphs (2) and (2A) below) are satisfied.

(2) The first condition is that the accounting arrangements allowing the departure also require appropriate adjustments, in the form of credits, to be made if the whole or any part of an amount taken or estimated to represent an amount of bad debt is paid or otherwise ceases to be an amount in respect of which such a departure is allowed.

(2A) The second condition is that, in determining the credits and debits to be brought into account in respect of exchange gains and losses, the accounting arrangements allowing the departure require a debt—

(a) to be left out of account, to the extent that such a departure is allowed; and

(b) to be taken into account again, to the extent that it is represented by credits brought into account under sub-paragraph (2) above.

Loan relationships for unallowable purposes

13.—(1) Where in any accounting period a loan relationship of a company has an unallowable purpose,

(a) the debits, and

(b) the credits in respect of exchange gains,

which, for that period fall, in the case of that company, to be brought into account for the purposes of this Chapter shall not include so much of the debits [or credits (as the case may be)][2] given by the authorised accounting method used as respects that relationship as, on a just and reasonable apportionment, is attributable to the unallowable purpose.][1]

[(1A) Amounts which, by virtue of this paragraph, are not brought into account for the purposes of this Chapter as respects any matter are in consequence also amounts which, in accordance with section 80(5) of this Act, are not to be brought into account for the purposes of corporation tax as respects that matter apart from this Chapter.][3]

(2) For the purposes of this paragraph a loan relationship of a company shall be taken to have an unallowable purpose in an accounting period where the purposes for which, at times during that period, the company—

(a) is a party to the relationship, or

(b) enters into transactions which are related transactions by reference to that relationship,

include a purpose ("the unallowable purpose") which is not amongst the business or other commercial purposes of the company.

(3) For the purposes of this paragraph the business and other commercial purposes of a company do not include the purposes of any part of its activities in respect of which it is not within the charge to corporation tax.

(4) For the purposes of this paragraph, where one of the purposes for which a company—

(a) is a party to a loan relationship at any time, or

(b) enters into a transaction which is a related transaction by reference to any loan relationship of the company,

is a tax avoidance purpose, that purpose shall be taken to be a business or other commercial purpose of the company only where it is not the main purpose, or one of the main purposes, for which the company is a party to the relationship at that time or, as the case may be, for which the company enters into that transaction.

(5) The reference in sub-paragraph (4) above to a tax avoidance purpose is a reference to any purpose that consists in securing a tax advantage (whether for the company or any other person).

(6) In this paragraph—

...

“tax advantage" has the same meaning as in Chapter I of Part XVII of the Taxes Act 1988 (tax avoidance)

Debits and credits treated as relating to capital expenditure

14.— (1) This paragraph applies where any debit or credit given by an authorised accounting method for any accounting period in respect of a loan relationship of a company is allowed by generally accepted accounting practice to be treated, in the accounts of the company, as an amount brought into account in determining the value of a fixed capital asset or project.

(2) Notwithstanding the application to it of the treatment allowed by generally accepted accounting practice, the debit or credit shall be brought into account for the purposes of corporation tax, for the accounting period for which it is given, in the same way as a debit or credit which, in accordance with generally accepted accounting practice, is brought into account in determining the company's profit or loss for that period.