'Fairly represents'--examining the boundaries of tax and accountancy

23/10/2015

Tax analysis: What are the implications of the First Tier Tribunal's (FTT) decision in the GDF Suez case to dismiss an appeal where a contingent debt asset had been transferred and the taxpayer's accounts correctly recorded this in a manner that was compliant with Generally Accepted Accounting Principles (GAAP)? The FTT found HMRC had correctly applied section 84 of the Finance Act 1996 (FA 1996) and found a tax liability because the transaction fairly represented profits of the tax payer. Vimal Tilakapala, partner at Allen & Overy and co-head of its UK tax practice, examines the judgment.

Original news

GDF Suez Teeside Limited (Formerly Teeside Power Limited) v HMRC [2015] UKFTT 0413 (TC)

The FTT has ruled in favour of HMRC in a case related indirectly to the collapse of Enron. The ruling means that the taxpayer will have to bring an amount of nearly £195m into charge to tax. The case involved the interpretation of FA 1996, s 84 and in particular consideration of the meaning of 'fairly represent'. It was determined here that the taxpayer's accounts although accepted as GAAP compliant did not 'fairly represent' profit for tax purposes in respect of the transactions in question and an additional taxable credit was therefore identified.

What did the FTT have to decide in this case?

This is a case relating indirectly to the collapse of Enron. The case is an interesting one as it is one of a number of recent cases where the courts have had to consider the boundaries between tax and accounting.

Here the court had to decide whether GAAP compliant accounts could be overridden in order to defeat a tax avoidance scheme that relied on the application of particular accounting rules in order to give rise to a tax advantage for the taxpaying company.

The focus of the case was on whether the phrase 'fairly represent' used in the loan relationship legislation allowed the GAAP compliant accounting to be overridden for tax purposes.

The case relates to transfers by the taxpayer company (in 2006 and 2007) to a non-UK resident subsidiary of accepted financial claims against certain Enron companies in return for shares in the subsidiary. The financial claims were regarded as contingent debts and so accepted to be within the loan relationships regime.

The accounting treatment required no recognition of profit on the transfer (or subsequently). HMRC submitted that the taxpayer made a profit on transfer of approximately £200m represented by the value of the shares received in the subsidiary. This was supported by an independent and contemporaneous valuation of the relevant claims.

The FTT found that the evidence showed that the taxpayer had made a profit as a result of the transfer by it of a contingent debt asset. It correspondingly found that the GAAP compliant accounting treatment of the transaction did not 'fairly represent' the profits and losses arising to the company in respect of its loan relationships as required by FA 1996, s 84 (now found in section 307(3) of the Corporation Tax Act 2009).

What is the relationship between accounting treatment and tax, and why is it so important in the taxation of debt and derivatives?

One of the core features of the legislation relating to loan relationships and derivatives is the reliance on a company's GAAP compliant accounts as the general basis for determining credits and debits to be brought into account for corporation tax purposes.

This is subject to various derogations in particular situations where as a policy matter the tax treatment is intended specifically to depart from the position set out in the accounts, for example:

- o connected company transactions for loan relationships
- o intra-group transfers for loan relationships and derivatives, and
- o hedging arrangements for loan relationships and derivatives

There are also rules that limit the ability of the accounts to determine the tax deductibility of debits. The main one being a statutory override in relation to deductibility where loan relationships or derivatives have been entered into for 'unallowable purposes'.

The use of the accounts in this way has been a feature of the legislation in this area since 1996.

Earlier attempts were made to align the tax treatment of financial contracts more closely to the accounting position but this was done in a far more prescriptive manner in Finance Act 1996 by specifying in detail what a suitable accounting method had to provide.

What does the case tell us about the accounting concept of 'true and fair' view and the tax law concept of 'fairly represents'?

The FTT saw a clear difference between these two concepts. It accepted that the taxpayer's accounts did indeed give a 'true and fair' view of its financial position even though they did not 'fairly represent' loan relationship profit or loss for tax purposes.

The case highlights the fact that not only are these distinct concepts, but that they also serve different purposes. The key aim of a 'true and fair' view is to give shareholders, investors or the market a view of the financial position of the company. It does not focus on what tax should be paid by that company which is what 'fairly represents' is considered (at least by the two judges in the FTT in this case) to do.

How, and when, does the 'fairly represents' override in the loan relationships regime operate?

This is a difficult question to answer, as there are a number of principles that seem to emerge from the decision.

First, the FTT concluded that although there can be differences between the accounting measure of profit and a 'fair view' of a company's taxable profit, in 'normal cases' the accounting measure will give a 'fair view'.

This leaves open the question of what is and is not 'normal'. Here the transaction was seen as abnormal as it was a structured transaction which used accounting rules to give rise to a tax benefit for the company. The inference here is that 'normality' can therefore be related to purpose.

Second, there was some focus by the FTT on the particular accounting principle relied on. Specifically, the FTT paid particular attention to the fact that FRS 5 applied a substance over form basis--in circumstances where the FTT thought that the tax result should have been determined on a more legalistic basis--respecting commercial and legal form. The FTT added here that it had concerns generally with allowing inherently subjective accounting principles such as FRS 5 to be relied on in the context of Disclosure of Tax Avoidance Schemes (DOTAS) reported transactions.

The principle here seems to be that subjective accounting principles such as those which apply where a substance over form approach is required cannot be relied upon where avoidance transactions are concerned.

There seems to also be a secondary principle here which is that accounting principles which involve looking at transactions on a group consolidated basis are potentially unsuited to determining taxable profit. This is because taxable profit should generally be determined on a solo company basis.

It is not easy to draw all of these principles together and there will be confusion in practice as taxpayers and their advisers try to apply them. This is unsatisfactory and an inevitable cause of uncertainty.

What can we learn about the concept of 'fairness' in tax from this case?

The case does not give much guidance on this point. At the heart of the case is the proposition that the end tax result would not have been a 'fair' one. This was assumed at the outset of the case.

It is not a surprising view for the judges to have taken--given that the transaction had been disclosed under DOTAS and the FTT described it as resulting potentially in the deferral and potential removal of profits from the UK tax net.

However, although not surprising, it is still disappointing that no attention at all was paid to determining what should be taken into account in assessing 'fairness'--as this is at the heart of the matter.

It remains therefore a subjective concept which requires value judgments to be made.

Has it followed the authorities in DCC Holdings, Versteegh and Greene King appropriately?

Each of these cases has considered the boundary between tax and accounting in different ways.

DCC Holdings (UK) Ltd v HMRC [2009] EWCA Civ 1165, [2009] All ER (D) 112 (Nov) was the first and most high profile example of HMRC seeking to establish the term 'fairly represent' as imposing a separate 'fairness' principle. The case involved a tri-partite repo transaction designed to give rise to a tax benefit under the very prescriptive tax rules applicable to repo transactions.

The 'fairly represent' issue was debated here at three separate judicial levels culminating in a Supreme Court judgment that decided the case by reference to an unrelated statutory interpretation principle--so avoiding the need to affirm or dismiss the 'fairly represent' argument.

The 'fairly represent' issue was, however, examined closely at Court of Appeal level. Here the judges' views differed. Moses LJ seemed to dismiss it--agreeing with the lower tier judge that there was no overriding principle--and it was a case of having to look very closely at the legislation in question. He quoted the earlier judge's view of FA 1996, s 84(1) as containing: 'no statutory justification for wafting a magician's wand scattering the stardust of fairness over the sums brought into account by section 84(1)'.

Rimer J agreed with Moses LJ on this point--finding no general principle here and concluding that the legislation in question (the repo legislation) had to be interpreted narrowly as it was prescriptive and very specifically drafted. Rix J's view was a little less clear--but again he did not identify a general fairness principle- deciding the case instead by looking at the legislation purposively 'taking into account the totality of the statutory material'.

It is arguable that the FTT decision in *GDF* is inconsistent with *DCC Holdings*--although it is of course possible to confine DCC to its facts given the very specific nature of the legislation being considered.

Versteegh Ltd and others v HMRC [2013] UKFTT 642 (TC) was another tax scheme--this time involving intra-group loans under which certain obligations were satisfied by the issue of shares--the accounting result being deductions for the borrower with no corresponding accounting receipt for the lender.

HMRC challenged the tax result of the transaction--arguing that the lender's accounts should properly show a lender's return in respect of the arrangement. This would be consistent in HMRC's view with the substance of the transaction. The accounting treatment here again involved a degree of subjectivity in determining the substance over form applicability of FRS 5.

Here, the FTT acknowledged that there was scope for different views on accounting in the particular scenario and the taxpayer's accounts were not therefore incorrect. As a result, HMRC was not able to impose its alternative view. This aspect of the judgment was not challenged in the subsequent Upper Tribunal hearing (*Versteegh Limited & others v HMRC* [2015] UKUT 75 (TCC), [2015] STC 1222).

The case seems to demonstrate the primacy of GAAP compliant accounts--suggesting that for HMRC to be able to challenge the accounts a high bar is needed as it must show not only that its alternative approach is GAAP compliant but that the taxpayer's approach is not. The 'fairly represent' argument was not a feature of this case.

In general terms this case is similar to *GDF*. Both involve accounting based avoidance schemes, neither relies on a very specific area of legislation (such as the repo provisions) and both involve FRS 5. It is therefore harder to reconcile with *GDF*--although again it can of course be limited to its specific facts.

Greene King PLC and another v HMRC [2014] UKUT 0178 (TCC) also involved an avoidance scheme that relied in part on accounting--this time in relation to an intra-group novation of interest obligations under loans in return for preference shares. It also involved consideration of FRS 5.

Here the FTT was able to conclude that the accounting treatment adopted by the tax payer was not in accordance with GAAP (and this finding of fact was not overturned by the Upper Tribunal). There was, therefore, no need to consider whether a GAAP compliant accounting result could be overturned. There is therefore no inconsistency with *GDF*.

Do you agree with the conclusions of the FTT?

The decision is a surprising one. It states clearly that 'fairly represent' is being used as 'an anti-avoidance rule to stop accounting principles being used as a way of taking profits out of the tax system'.

The clarity of the judgment is admirable. However, whether previous case law or indeed the legislation itself supports the position taken is questionable.

The reference to the proposed Summer Finance Bill 2015 changes to the loan relationship code as support for the approach being taken is difficult to understand. It is fair to say that the broader anti-avoidance provisions may have been adopted in part as a result of HMRC not pursuing the 'fairly represent' argument--but this is not by any means an acceptance of HMRC's view of the 'fairly represent' argument.

Do the proposed changes (and repeal of the 'fairly represents' override in particular) affect the decision in this case? Could the FTT have reached the same decision under the new rules?

The anti-avoidance provisions in the revised loan relationship code are much more comprehensive than those in the current code.

Rather than reliance on provisions limiting debits arising on loan relationships in certain circumstances, the new rules have a broad concept of 'loan related tax advantages' that arise from 'relevant avoidance arrangements'. Where these are identified they can be counteracted by HMRC.

These provisions capture situations where tax advantages arise from bringing into account debits, avoiding bringing into account credits as well advantages arising from manipulation of the timing of recognition of credits or debits. In short, HMRC will have far more ability to challenge a company's tax position irrespective of the appropriateness of accounting principles. The reliance on the accounts as the arbiter of taxability will therefore be significantly diminished.

The scheme in *GDF* is unlikely to have been possible under the new rules.

The effect of the decision will therefore be limited prospectively. It may however, absent an appeal, have an impact on existing cases involving the current legislation that are yet to be determined.

Do you think it likely the case will be appealed by the taxpayer or HMRC?

The judgment contains the standard wording that a party affected has a period of 56 days from the handing down of the judgment to apply to the FTT for permission to appeal. This time expired on 6 October 2015. The taxpayer has lodged an application with the FTT for permission to appeal but this has not yet been determined. Given the difficulties reconciling the decision with other decisions from the Upper Tribunal and the amount at stake, it would be disappointing if the FTT does not grant permission to appeal.

Interviewed by David Bowden.

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