Analysis

Union Castle: is the 'fairly represent' test fair?

Speed read

In *Union Castle Mail Steamship Co Ltd v HMRC*, the Court of Appeal dismissed the taxpayers' appeals concerning the application of the derivative contracts rules to a scheme involving the issue of bonus shares which carried a right to substantially all of the returns on certain derivatives. The court found, inter alia, that the 'fairly represent' requirement for deductibility was not met. Following *GDF Suez*, 'fairly represent' was a separate and overriding condition that had to be satisfied in computing the debits and credits to be brought into account. The court's conclusion that this requirement constitutes a free-standing override of accounting principles appears, in the author's opinion, to be something of a one-way street: despite judicial comment that the principle was to be applied in an even-handed manner, there are no instances where this has happened.

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Special law versus general law

The litigation in *Union Castle Mail Steamship Co Ltd v HMRC* [2020] EWCA Civ 547 concerned the taxation of derivatives held in an investment fund.

A tax system can either apply its general tax rules to derivative contracts or enact a special code of rules applying to derivatives. For coherence of the tax system, the balance of advantage lies in having a special code.

In the 1990s, the UK took a policy decision to introduce special codes of taxation for derivatives and for financial instruments generally. This decision was manifested in a trilogy of legislation: FA 1993 (foreign exchange gains and losses); FA 1994 (financial instruments); and FA 1996 (loan relationships).

In 2002, foreign exchange gains and losses were split between loan relationships and derivative contracts, leaving two categories of financial instruments to which these broadly similar legislative codes apply. The main difference between them is that loan relationships are accounted for on an amortised cost basis and derivative contracts on a fair value basis.

The tax system produced by these changes is logical and straightforward. The UK taxes debt instruments on an accruals basis, equity instruments on a realisations basis and derivative contracts on a fair value basis.

The issues in this case

Where special rules apply, they will in general displace general legal rules. However, there will come a point when the application of the special rules is ousted by the general rules. Had such a point been reached? That was the question which the Court of Appeal had to decide.

There was a single judgment by Lord Justice David Richards, which raises a wide range of issues, namely:

1. the 'fairly represent' issue;
2. the 'arising from' issue;
3. the categorisation issue; and
4. the distributable profits issue.

The Upper Tribunal ([2018] STC 2034) had decided issue (1) in favour of, and issue (2) against the appellant. The Court of Appeal overruled the Upper Tribunal on (1) and affirmed the Upper Tribunal on (2).

The facts

The facts giving rise to these issues were as follows:

(i) Caledonia is an approved investment trust (AIT) which as such is subject to a special accounting and tax regime. This includes the obligation to distribute at least 85% of profits to investors.
(ii) Caledonia held shares as part of its investment business. The directors wanted to insure against a fall in value of the shares. Prior to July 2008 it was doubtful whether the company could hold derivative contracts.
(iii) Its wholly-owned subsidiary, Union Castle, bought put options over the shares to protect investors against downwards movement in share values. The cost of the put options was £16.6m.
(iv) The put options were derivative contracts, so that Union Castle was required to account for the put options at fair value under IAS 39.
(v) The share values fell, so the value of the put options correspondingly increased. They were in-the-money options with a close-out value of £41.2m.
(vi) Union Castle issued ten 'A' bonus shares to Caledonia for every ordinary share held, using £5,020 of share premium account to pay up the shares. The bonus shares carried the right to be paid 95% of any close-out payment (the 'option cash settlement amount') receivable by Union Castle.
(vii) On issuing the bonus shares, Union Castle derecognised 95% of the fair value of the put options, giving rise to an accounting loss of £39,149,128.
(viii) Caledonia agreed to make a capital contribution to Union Castle of the option cash settlement amount.
(ix) Union Castle reclassified the capital contribution to distributable profits.
(x) Union Castle then paid a cash dividend of the option cash settlement amount to its parent.
(xi) In its corporation tax self-assessment return for the accounting period ended on 31 March 2009 Union Castle claimed a deductible loss of £39,149,128.
(xii) HMRC disallowed the claim and Union Castle appealed against this decision. The appeals to the First-tier Tribunal and Upper Tribunal were dismissed.

The question was whether the accounting loss at step (vii) was a deductible loss for tax purposes.

1. The 'fairly represent' issue

The legislation

The derivative contracts legislation was contained in FA 2002 Sch 26 (now CTA 2009 Part 7).

As the Court of Appeal stated (at para 2) that FA 2002 Sch 26 'contains an exhaustive code for the taxation of profits arising from derivative contracts'. The essence of the special rules is that (a) all gains and losses arising from derivative contracts are taxed and relieved as income; and (b) gains and losses are measured by applying fair value accounting.

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The question was, whether and to what extent tax law should follow accounting standards for the recognition of gains and losses on derivative contracts, in order to 'fairly represent' the profits of the company from its derivative contracts within FA 2020 Sch 26 para 15(1).

Derivative contracts, when their use became widespread in the 1980s, obliterated the distinction between capital gains and income, realised and unrealised profits, dividends and interest.

The response of accounting regulators was to require all derivative contracts to be taken to balance sheet and accounted for at fair value.

The distinguishing feature of fair value accounting, as opposed to accruals accounting, is that the realisation principle does not apply. Fair value accounting does not require a transaction with a third party to give rise to a profit or loss. A change in values is of itself an accounting event, being taken to the profit and loss account as a receipt or expense.

The response of tax policy makers was, as noted, to introduce special codes of rules for the taxation of financial instruments. That policy decision had two logical and necessary consequences:

- Tax follows the accounts: That has always been the general principle for the taxation of trading profits, but it has assumed a heightened significance because of the use of fair value accounting. Hence the principle that 'tax follows the accounts' is given statutory force in the codes.
- Ring-fencing: A comprehensive derivative contracts code is a legislative direction to ring-fence gains and losses on such contracts.

Statutory overrides

However, Parliament was concerned about leaving accountants to their own devices. So the legislation followed the well-established pattern (now contained in CTA 2009 s 46) of saying that tax follows the accounts subject to statutory overrides, i.e. unless the law provides to the contrary.

In most cases, these statutory overrides are specific; for example, the non-deduction of depreciation charges, transfer pricing adjustments, impairment losses and releases of connected company loan relationships. In some cases, they are systematic and structural; for example, as in the carried-forward loss rules and corporate interest restriction introduced in 2017.

In one case, however, the override was general and open-ended. This was the requirement that, to be adopted for tax purposes, the commercial accounts had to 'fairly represent' the profits of the business (now replaced by the differently worded CTA 2009 ss 455B–455D and ss 698B–698D, which contain the yardstick of 'tax avoidance').

At the time in question, the relevant provision of FA 2002, Sch 26 provided in para 15(1)(a):

> '(1) The credits and debits to be brought into account in the case of any company in respect of its derivative contracts shall be the sums which, when taken together, fairly represent, for the accounting period in question–
> (a) all profits and losses of the company which … arise to the company from its derivative contracts and related transactions…'

So, the question was, notwithstanding that the accounting treatment was accepted as being correct, did the loss 'fairly represent' the profits and losses of the business?

The Court of Appeal's decision

The court adopted Henderson LJ's exposition of the scope of the 'fairly represent' requirement in *GDF Suez Teeside Ltd v HMRC* [2018] EWCA Civ 2075 (at para 93), where he observed: 'The concept of fairness is central both to the development and application of accounting standards, and to any process of judicial appraisal by a court or tribunal.'

The judicial approach this embodies can be summed up in these terms: 'The accountants are sometimes too clever for their own good. In a given case, the accountants may correctly apply accounting standards, but produce a result which conflicts with common sense and fairness. Where this happens, then tax should *not* follow the accounts.'

Lord Justice David Richards explained the scope of the 'fairly represent' principle as a 'freestanding criterion' which served as a general 'override' of accounting computation of gains and losses (at para 47): 'While this court upheld the UT's decision in *GDF Suez*, it did so on the basis of a much broader reading of the effect of the words "fairly represent". That reading specifically rejected the view of the UT in *GDF Suez* that they could not be regarded as a freestanding criterion, which was not bound by the accounting treatment of profits and losses and could indeed override such treatment. The same applies in the present case…'

This led the court to conclude that the accounting entry did not 'as a matter of legal analysis or economic reality, fairly represent a loss to Union Castle'. This was because: (i) the loss had been created by the issue of the bonus "A" shares; (ii) Union Castle remained beneficially entitled to the cash flows of close-out both before and after the issue of the bonus "A" shares; (iii) Union Castle incurred no liability.

The reasoning of the Court of Appeal was summed up with lapidary concision by Lord Justice David Richards (at para 58): 'These factors demonstrate … that the debit required by IAS 39 to be made in Union Castle's accounts by the derecognition did not, as a matter of legal analysis or economic reality, fairly represent a loss to Union Castle for the purposes of [FA 2002 Sch 26 para 15(1)]. Union Castle lost no asset nor incurred a liability … The payment of a dividend is not a loss. It is the very reverse of a loss: it is the distribution of profits.'

2. The 'arising from' issue

Did the accounting loss fall into the category of 'all profits and losses of the company which … arise to the company from its derivative contracts and related transactions' within FA 2002 Sch 26 para 15(1)(a)?

The Upper Tribunal had concluded (at paras 39–40) that, if there was a loss for the purpose of Sch 26, it did not 'arise from' the derivative contracts, but from the issue of the bonus 'A' shares. There was therefore no direct causal connection between the losses and the derivative contracts. The accounting loss was 'too remote'. The term 'related transactions' was defined as the acquisition or disposal of derivative contracts, and it did not include a wider class of transaction. The Court of Appeal agreed with this reasoning (see paras 67–76).

What the court was saying was that the loss (if any) fell outside the ring-fenced derivative contracts profits and losses, but it came within general tax rules. So, the issue concerns the scope of ring-fencing.

3. The categorisation issue

The question is whether and to what extent derivatives should be regarded as a third category of financial instrument beyond debt and equity.

Though the derivatives contract regime is comprehensive, it is not all-embracing. There are a number of exclusions. In particular, there has always been an

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important exclusion for equity hedges (FA 2002 Sch 26 paras 4(2B) and 12(1), (11A); CTA 2009 s 591(3)).

This did not apply in this case, because the shares were in the parent, the options in the subsidiary.

Caledonia held shares for investment purposes. The only purpose of the put options was to produce a gain which would counteract a fall in value of the shares. The aim was economic neutrality. Given the obligation to distribute the bulk of its profits, an investment trust cannot be a vehicle for stockpiling profits.

The Court of Appeal decision serves to highlight missing or asymmetric tax hedging rules. A taxation of the arrangements as a whole according to their true economic content was not possible.

As the Court of Appeal points out, 'the "fairly represent" test requires the court to examine the totality of the relevant transaction in its factual context' (para 52). So, if the triggering of the 'fairly represent' override requires a consideration of the commercial context, this was also a factor which could have been taken into account.

4. The distributable profits issue

Could the derecognition of the value of the put option contracts give rise to distributable profits?

Distributions can only be paid out of 'profits available for distribution' (Companies Act 2006 s 863(1)). The question is then whether a capital contribution constitutes 'realised profits' for company law, accountancy purposes and tax purposes?

The court observed (at paras 61–64) that Union Castle did not have sufficient distributable profits to fund the proposed distribution on the bonus 'A' shares. This was achieved by the making of a capital contribution by the parent, which the subsidiary credited to distributable profits, and then returned by way of dividend.

The court commented (at para 10): 'As the capital contribution would be made for no consideration, its entire amount would be credited to distributable reserves.'

It is not clear whether this sentence is summarising the letter of 21 November 2008 (in which Caledonia undertook to pay a capital contribution corresponding to the amount of the option cash settlement) or expressing the court's own conclusion.

The Privy Council in *Kellar v Williams* [2000] 2 BCLC 390 (at 395) held that a company could 'increase its capital without a formal allocation of shares'. In such an event, Lord Mackay observed that such capital would 'become like share premium, part of the owner's equity'.

This was endorsed by the Court of Appeal in *Blackburn v HMRC* [2009] STC 188 (at para 30). Lord Neuberger went on to observe that there was no standardised accounting treatment.

Since Lord Neuberger's observations, accounting guidance has been introduced in ICAEW TECH 02/17BL *Guidance on realised and distributable profits under the Companies Act 2006*. Para 3.14(c) says that a capital contribution in the form of cash is a realised profit unless it is received in the form of a loan.

However, a transaction in which a parent makes a gift of capital of 100 to a subsidiary, which the subsidiary accounts for as an income receipt and immediately returns to the parent in the form of an income distribution goes against the principle that distributions can only be made out of profits which have borne tax.

As the court commented (at para 64): 'There was therefore … a significant shortfall in the distributable profits required to pay the proposed dividend. This was overcome by writing back the debit of £39,149,128 … The effect was to pay the dividend out of profits constituted by the very debit said to be a loss. This appears to be a remarkable piece of "now you see it, now you don't" accounting.'

The key issue

The conclusion that 'fairly represent' constitutes a free-standing override of accounting principles, gives rise to two comments.

First, what has 'fairly represent' got to do with the price of fish? If a trainee bookkeeper were to say, 'I can't get the debits and credits to balance, but the result is fair', he would be advised to seek an alternative career. When a member of his cabinet objected that a policy was unfair, Lord Salisbury as prime minister advised him to consult the Archbishop of Canterbury.

Secondly, as it has been applied by HMRC and interpreted by the courts, the 'fairly represent' principle appears to be something of a one-way street.

In *HMRC v Smith & Nephew Overseas Ltd* [2020] EWCA Civ 299, Rose LJ observed (at para 42) that the 'fairly represent' principle was to be applied in an even-handed manner: 'the override is … intended to operate in favour of the taxpayer as well as in favour of HMRC. It may lead, for example, to profits being left out of account for tax purposes, even though they are included in the company's accounts in accordance with GAAP.'

The problem is that there are no instances where this has happened.

Take the example of a company, which has an annual turnover of £50,000 and a bank debt of £50,000. On account of the coronavirus lockdown its turnover in 2020 falls to £0. In the hope that the company might recover, and so be able to pay back at least some of its liabilities, the bank releases £25,000 of the loan. The company's accountants, correctly following IAS 39, para 39.1, derecognise £25,000 of the liability and report in the 2020 accounts a profit of £25,000.

If the company were to argue that the accounting entry does not 'fairly represent' a commercial profit of £25,000, on which the company is taxable, that argument would be unlikely to succeed. The reason is simple. If taxpayers and HMRC could include or exclude amounts from the computation of loan relationship profits when it suited their respective interests, there would be no certainty.

The classic idea of law is palm-tree justice. A court decides each case in the light of its individual facts and circumstances, in order to secure a just result. However, in certain areas of law, in particular commercial law and tax, it has been recognised that it is more important to achieve certainty than fairness. This is in order that those affected by the system can discover their rights, obligations, powers and liabilities with a reasonable degree of certainty.

I ask a simple question: if an IAS 39 accounting loss is not recognised for tax purposes, why is an IAS 39 accounting profit so recognised? There is a danger of turning the tax system into a game of snakes and ladders, in which the snakes are marked 'taxpayers only', and the ladders marked 'HMRC only'. ■

- Cases: *Union Castle v HMRC and Ladbrokes v HMRC* (28.4.20)
- Cases: Smith & Nephew Overseas Ltd v HMRC (10.3.20)
- Tax and the City review for May 2020 (Mike Lane & Zoe Andrews, 7.5.20)

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