The Union Castle Steamship Company Ltd v HMRC – First-tier Tribunal decision

The First-tier Tribunal (FTT) has found for HMRC in a lead case concerning a disclosed tax arrangement where a deduction was claimed for a debit arising from the partial derecognition of financial assets relating to derivative contracts. This is the third decision of the FTT where HMRC has been successful in denying relief for debits claimed under disclosed arrangements involving the derecognition of financial assets; *Abbey National Treasury Services v HMRC* (*ANTS*) involved the derecognition of derivative contracts following a bonus issue of shares to a parent company and *Stagecoach Group plc v HMRC (Stagecoach*) involved the partial derecognition of a loan relationship asset on entering into a forward subscription agreement with a subsidiary.

The Union Castle Steamship Company Ltd (Union Castle) claimed a deduction, under the derivative contracts regime, for a £39m debit in respect of the partial derecognition of financial assets relating to FTSE 250 related derivative contracts which were carried on the balance sheet (the Options). The accounting derecognition was required following a bonus issue of shares by Union Castle to its parent company Caledonia Investments plc (Caledonia) under which 95 percent of the cash from the Options was to be distributed to Caledonia.

The FTT denied relief for the debit on the basis that Union Castle had not incurred a loss because, irrespective of the accounting, it was entitled to receive exactly the same amounts under the Options before and after the issue of the shares. This was sufficient for the arrangement to fail.

However, in case the decision is appealed, the FTT considered the other issues and, in each case, found for the taxpayer, as follows:

- If there were a loss, this did arise from the derivative contracts;
- The requirement that a debit should "fairly represent" a loss from a derivative contract has two roles; to identify debits and credits which are appropriate to a particular accounting period (the timing role) and to identify those debits and credits which are attributable to derivative contracts rather than something else (the attribution role). Applying this to the circumstances of Union Castle, the loss, had there been one, would have satisfied this fairly represents requirement;
- If the derecognition debit were recognised directly in equity (relevant for one of the follower cases which applied UK GAAP rather than IFRS), such a debit is not required to satisfy the requirement that it fairly represents a loss from a derivative contract; and
- The bonus issue of shares was not a transaction within the scope of the transfer pricing rules, so no adjustment was made under those rules.

Interestingly, the FTT in *Union Castle* came to their own view on the issues and did not follow the approach taken in the ANTS judgement in relation to whether the loss arose "from" a derivative contract and the application of the transfer pricing rules.

It is understood that no appeal is being made in the *ANTS* and *Stagecoach* cases but it is not yet known whether there will be an appeal in the *Union Castle* and follower cases.

Factual background and accounting treatment

In December 2008, Union Castle was a party to the Options.

On 21 December 2008, Union Castle made a bonus issue of shares (A Shares) to its parent company Caledonia. These shares entitled Caledonia to receive a dividend equal to 95 percent of the cash flows arising on the close out of the Options.

In accordance with IAS 39, prior to the issue of the A Shares, Union Castle carried the Options as financial assets on its balance sheet at fair value. The rights attaching to the A Shares effectively transferred 95 percent of the economic benefits and risks and rewards associated with the Options to Caledonia and so Union Castle derecognised or credited 95% of the financial asset and debited the income statement.

Summary of decision

The FTT considered the following issues.

Should the derecognition debit have been recognised in the income statement or in the statement of changes in equity (referred to as the Accounting Issue)

Union Castle's accounting treatment was not disputed by HMRC except that it was contended that the transaction should be regarded as being with Caledonia in its capacity as owner such that the debit should be recognised in the statement of changes in equity rather than the income statement.

The FTT, on balance, preferred the approach of the accounting expert for the taxpayer that the derecognition debit should be recognised in the income statement, though it was accepted that recognising the debit in the statement of changes in equity would also be valid (paragraph 28). However, this was not a significant matter because the derivative contracts regime picks up debits and credits in either statement.

Did the accounting debit fairly represent a loss from a derivative contract (referred to as the Loss Issue)?

The legislation required that "[t]he credits and debits to be brought into account … shall be the sums which, when taken together, fairly represent, for the accounting period in question … all profits and losses of the company which … arise to the company from its derivative contracts and related transactions" (paragraph 15 Schedule 26 FA 2002).

This was considered in three parts

Was there a loss?

Counsel for the taxpayer (Jonathan Peacock QC) contended that there was a loss of 95 percent of the financial asset because before the derecognition transaction Union Castle had 100 percent of the economic benefit from the Options but only 5 percent afterwards.

However, the FTT found that there was no loss because Union Castle was entitled to exactly the same amounts under the Options both before and after the issue of the A Shares albeit that it was then required to distribute 95 percent of the cash benefit to Caledonia (paragraph 49).

It followed that Union Castle was denied relief for the derecognition debit.

The other issues were considered in case there is a further appeal.

If there is a loss, did it arise from the derivative contracts?

Counsel for HMRC (Julian Ghosh QC) contended that the source of the loss (if there is one) is the issue of the A Shares not the Options such that there was no loss "from" the derivative contracts.

However, the FTT decided that such a loss did arise to Union Castle from its derivative contracts, being the Options (paragraph 52). In coming to this view, the Tribunal noted that they were unable to adopt the reasoning in the ANTS case, in that it would be inconsistent with the principles of double entry bookkeeping (and the accounting evidence in Union Castle) to say that the source of the credit was the derecognition of the derivative contract but the source of the debit was the issue of the shares.

Does the £39m debit "fairly represent" a loss?

The FTT found that the "fairly represents" wording has two roles; to identify debits and credits which are appropriate to a particular accounting period (the timing role) and to identify those debits and credits which are attributable to derivative contracts rather than something else (the attribution role). As a result, the loss, had there been one, would have satisfied the fairly represents requirement (paragraph 56).

In summary, in relation to the Loss Issue, the Tribunal found that there was not a loss as a result of the derecognition debit but if there had been it would have been a loss from the derivative contracts and satisfied the fairly represents requirement.

Is a debit which is taken to equity subject to the fairly represents a loss from a derivative contract wording (referred to as the Gateway Issue)?

The derivatives contracts regime takes as a starting point the debits and credits recognised in the profit and loss account (which was relevant to Union Castle) and certain listed statements, including the statement of changes in equity.

One of the followers to the lead case (Ladbrokes) prepared its accounts using UK GAAP (rather than IAS as used by Union Castle). As a result, the derecognition debit was recognised directly in equity.

Relief was, in principle, available for the Ladbrokes derecognition debit via a provision which taxes and allows debits and credits "in respect of" a derivative contract which are taken directly to equity without going through any of the listed statements (paragraph 25A Schedule 26 FA 2002).

This resulted in a question as to whether, as Counsel for HMRC contended, such a debit is required to satisfy the requirement that it fairly represents a loss from a derivative contract. The FTT found that there was no such requirement (paragraph 67).

Julian Ghosh QC, for HMRC, drew an analogy with the Stagecoach FTT decision where a loan relationship derecognition debit was taken to the carrying value of an investment in a subsidiary and it was found to be subject to the fairly represents a loss from a loan relationship wording. However, the Tribunal said that the Stagecoach decision was of little, if any, assistance because the observations there were obiter and related to the loan relationships code where the drafting is not identical.

Shortly prior to the hearing, HMRC applied to introduce an additional argument that the derecognition debit was not "in respect of" a derivative contract such that the requirements of paragraph 26A Schedule 26 FA 2002 were not satisfied. Having noted that the "in respect of" issue had been considered in the Stagecoach case following an application at the commencement of the hearing, the application was refused because the issue only related to Ladbrokes whereas the statement of agreed facts and expert accounting evidence related to the Union Castle case (paragraphs 8 to 15).

Whether, if Union Castle would otherwise be entitled to a deduction is respect of the accounting debit, such a deduction should nevertheless be eliminated or reduced by a transfer pricing adjustment (referred to as the Transfer Pricing Issue)

Julian Ghosh QC, for HMRC, contended that parties acting at arm's length would not have entered into the transaction involving the issue of the A Shares and so the transfer pricing provisions should be applied to treat Union Castle as though it had not issued the shares, thereby eliminating the debit for which relief was claimed. This was effectively the argument that had been accepted by the FTT in the ANTS case.

However, the FTT declined to follow the ANTS decision and found that the issue of bonus shares was not a transaction which is within the scope of the transfer pricing rules (paragraph 87). In coming to this view, the Tribunal placed reliance on the distinction in the OECD guidelines between shareholder and non-shareholder transactions.

Points of wider significance for taxpayers

Although a decision of the FTT is not binding on any other court, it can represent persuasive authority.

In some respects, the decision is of limited interest prospectively because anti-avoidance provisions have been introduced to counter arrangements with similar features and the "fairly represent" wording at the centre of the case has been repealed by Finance (No. 2) Act 2015 with effect for periods beginning on or after 1 January 2016.

Of wider potential impact is the finding, contrary to the FTT decision in the ANTS case, that shareholder-type transactions, such as a bonus issue of shares, should be treated as falling outside the scope of the transfer pricing provisions. This issue may be resolved if there is an appeal to a higher court.

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