TC04424

Appeal number: TC/2012/02518
TC/2012/02614
TC/2012/02613
TC/2012/02722

Corporation tax - loan relationship code – repo over interest coupons – legal and accounting concepts –interest coupons recognised in accounts during repo term - whether fair representation of profits – whether arising from loan relationship – DCC Holdings considered - need for symmetry – HELD – Accounting treatment is paramount – recognition is fair representation of profits – interest coupons arose from loan relationship – DCC Holdings approach to symmetry not relevant - appeal dismissed.

FIRST-TIER TRIBUNAL
TAX CHAMBER

Cater Allen International Limited — **First Appellant**

Abbey National Treasury Services Plc — **Second Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS — **Respondents**

TRIBUNAL: JUDGE Rachel Short
Nicholas Dee (Member)

Sitting in public at Royal Courts of Justice, the Strand London on 3 and 4 February 2015

Mr Kevin Prosser QC and Zizhen Yang of Pump Court Tax Chambers instructed by Slaughter & May for the Appellants
Mr David Milne QC and Mr David Yates of Pump Court Tax Chambers, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents.

DECISION

1. This is a decision in principle relating to a transaction referred to as Ariel I entered into by Abbey National Treasury Services Plc ("ANTS") in its accounting period ending 31 December 2007. It is understood that the parties will apply the decision in respect of this transaction to the appeals made in respect of Ariel I and II (Appeal numbers TC/2012/02613, TC/2012/02614 and TC/2012/02722) and Caliban, in which Cater Allen International Limited is the Appellant (Appeal number TC/2012/02518).

2. The Tribunal heard this appeal having heard on previous days the appeal concerning the Umbriel I and II transactions to which ANTS was also a party. These are recorded as decision numbers TC/2012/02613 and TC/2012/02722.

3. This is an appeal by ANTS against a decision of HMRC on 16 September 2011 that amounts included in ANTS' income statement for the year ended 31 December 2007 representing interest on floating rate notes subject to a repo should be treated as taxable credits under the loan relationship rules.

Preliminary Matters

4. Mr Prosser submitted on Friday 30 January a supplemental skeleton argument for the Appellant, ANTS. Mr Milne did not object to these arguments being raised although the skeleton had been served late.

5. There is no material dispute as to the facts between the parties. The following facts are agreed as set out in the agreed statement of facts provided to the Tribunal.

Agreed Facts

6. ANTS is a UK incorporated and tax resident company which is part of the Banco Santander Group whose ultimate parent is the Spanish entity, Banco Santander SA ("Santander").

7. ANTS acquired two mortgage backed floating rate securities ("FRNs") on 6 Sept 2006 from Santander for 2.3bn Euros and 2.6bn Euros respectively issued by Irish resident securitisation vehicles in the Santander group. It is accepted that these were acquired for commercial purposes. They paid interest quarterly, in Euros. The first interest payment date for 2007 was 30 March.

The Repo Agreement

8. On 9 March 2007 ANTS and Santander entered into a sale and option deed (the Repo) under which ANTS sold to Santander the right to receive interest under the FRNs comprising interest accruing from 1 Jan 2007 up to but excluding 13 July 2007. Two quarterly coupons were payable during this period, one on 30 March 2007 and one on 29 June 2007. Santander paid ANTS Euro 81,515,554 under this Repo (the

Repo Purchase Price). The FRNs were held in non-certificated form in Euroclear and Euroclear was not notified of the transfer of the right to receive interest under the Repo. Interest payments continued to be made by Euroclear to ANTS and ANTS, acting in capacity as bare trustee, paid those interest payments on to Santander.

The Option Terms.

9. The Repo terms included options (the "Cross Options") which were exercisable by both parties up to and including 2 July 2007. ANTS had a call option and Santander had a put option. The subject of the options was Santander's right to the interest under the FRNs. The exercise of either option entitled ANTS to "*such of the Property as remains outstanding, including without limitation, all present and future claims, causes of action, payment and proceeds thereof*".

10. "Property" was defined in the Repo as the right to receive payments of interest accruing on the FRNs to the extent that such payments comprised interest accruing from and including 1 January 2007 up to but excluding 13 July 2007. The price payable by both parties under the options was the same; the original Repo Purchase Price minus the interest actually paid on the FRNs plus interest at one month Euribor minus 1 basis point.

11. The option terms stated that no manufactured payments would be payable by Santander to ANTS in respect of the Property.

Interest Payments.

12. ANTS received interest of Euro 36,977,925.48 on 30 March and of Euro 38,994,296.56 on 29 June (the "Interest Coupons") and paid those amounts on to Santander.

13. On 2 July ANTS exercised its call option and paid the option price of Euro 6,165,782.99. The period of the Repo was therefore from 9 March 2007 to 2 July 2007.

14. ANTS' income statement for the 2007 accounting period included the two interest payments received on the FRNs.

Agreed Matters

15. The Repo (including the Cross Options) was properly treated as a "repo" for the purposes of the tax legislation, although its subject matter related to the coupons on the FRNs only and not the underlying securities.

16. The FRNs were loan relationships of ANTS. ANTS' disposal of its rights to interest arising on the FRNs was a related transaction for the purpose of s 84(5) Finance Act 1996, but was ignored by reason of paragraph 15(2)(a) Schedule 9 Finance Act 1996 because it was a repo arrangement. It was not treated as a related transaction in determining ANTS' liability to tax under s 84 Finance Act 1996.

17. The Repo meant that ANTS had no beneficial entitlement to the interest during the term of the Repo until the option was exercised. The Repo Purchase Price which ANTS received on entering into the Repo for the transfer of the interest to Santander was not itself a payment of interest.

18. ANTS' accounting treatment of the Repo Purchase Price and the interest which was received and paid on to Santander was in accordance with generally accepted accounting practice (GAAP); The FRNs continued to be recognised in ANTS balance sheet as a financial asset held at fair value. The Repo Purchase Price was recognised as a loan creditor. ANTS accounted for the interest received on the FRNs during the term of the Repo as interest received by itself.

19. The transaction was notified to HMRC under the Disclosure of Tax Avoidance Scheme Regulations (DOTAS).

Issue in Dispute.

20. The issue in dispute is whether the amounts credited to ANTS' income statement for the 2007 accounting period relating to the Interest Coupons should be treated as a taxable credit under the loan relationship rules in the Finance Act 1996.

Law.

21. *S 84 Finance Act 1996* sets out the basis of how amounts are to be brought into tax as debits or credits under the loan relationship code*:*

> *S84(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, 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 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 purpose of its loan relationships and related transactions.*

22. *S85A and s85B Finance Act 1996* explain that debits and credits are those recognised for accounting purposes

> S85A "*Subject to the provisions of this Chapter, (including in particular, section 84(1)), the amounts to be brought into account by a company for any period for the purposes of this Chapter are those that, in accordance with generally accepted accounting practice, are recognised in determining the company's profit or loss for the period"*.

S85B "Any reference in this Chapter to an amount being recognised in determining a company's profit or loss for a period is to an amount being recognised for accounting purposes –

(a) *in the company's profit and loss account or income statement*

(b) *in the company's statement of recognised gains and losses or statement of changes in equity, or*

(c) *in any other statement of items brought into account in computing the company's profits and losses for that period.*

23. s 84(5) defines a related transaction for these purposes:

(5) *In this Chapter "related transaction" in relation to a loan relationship means any disposal or acquisition (in whole or in part) of rights or liabilities under that relationship.*

24. *Paragraph 15 Schedule 9 Finance Act 1996* explains how repo and stock lending transactions are dealt with by the loan relationship code:-

(1) *In determining the debits and credits to be brought into account for the purposes of this Chapter in respect of any loan relationship, it shall be assumed that a disposal or acquisition to which this paragraph applies is not a related transaction*

(2) *This paragraph applies to any such disposal or acquisition of rights or liabilities under the relationship as is made in pursuance of any repo or stock-lending arrangements and as is, in the case of those arrangements, the disposal or acquisition effected by-*

(a) *the transfer by A to B mentioned in subsection (3)(a) below, or*

(b) *any transfer to A by B that gives effect to the entitlement or requirement described in sub paragraph (3)(b) below.*

(3) *In this paragraph "repo or stock-lending arrangements" means (subject to paragraph 3A) any arrangements consisting in or involving an agreement or series of agreements under which provision is made-*

(a) for the transfer from one person (A) to another (B) of any rights under that relationship;and

(b) for A subsequently to be or become entitled, or required-

(i) to have the same or equivalent rights transferred to him;or

(ii) to have rights in respect of benefits accruing in respect of that relationship on redemption

(3A) .....

(4) .....

(4A) *In consequence of sub- paragraph (1) above –*

(a) *the person transferring the rights mentioned in sub-paragraph (3)(a) above does not, as a result of the transfer, fall to be regarded for the purposes of this Chapter as ceasing to be a party to a loan relationship;*

but nothing in sub-paragraph (1) above prevents the person to whom those rights are transferred from being regarded for the purposes of this Chapter as being party to the loan relationship as a result of the transfer."

25. Case Authorities referred to:

DCC Holdings (UK) Ltd v Revenue and Customs Commissioners [2007] STC (SCD) 592 ("DCC Holdings SCD")

DCC Holdings (UK) Ltd v Revenue and Customs Commissioners [2008] EWHC 2429(Ch) ("DCC Holdings High Court").

DCC Holdings (UK) Ltd v Revenue and Customs Commissioners [2009] EWCA Civ 1165 ("DCC Holdings Court of Appeal").

DCC Holdings (UK) Ltd v Revenue and Customs Commissioners [2010] UKSC 58 ("DCC Holdings Supreme Court").

Greene King Plc v Revenue and Customs Commissioners [2014] UKUT 178 (TCC).

Evidence

26. *Main Documents seen*:

(1) Santander Structure Briefing Note "*Project Ariel – Accrued Interest Repo*" – 5 March 2007

(2) Santander Project Ariel Approvals Paper "*Accrued Interest Repo*" – 8 March 2007

(3) Sale and Option Deed between ANTS and Santander - 9 March 2007

(4) Deloitte Accounting Letter– 14 December 2007 "*Accounting for Project Ariel within the Abbey National Plc Group*"

27. The Tribunal received an expert witness report from Ms Eileen Patricia Baird, chartered accountant instructed by HMRC, dated 14 November 2013. Ms Baird's expert evidence was not disputed and her witness statement was taken as read. Ms Baird was cross-examined by Mr Prosser.

28. Ms Baird had been asked by HMRC to consider three questions (i) Why under IFRS the FRNs continued to be recognised as assets in the statutory financial statements of ANTS for the year ending December 2007 throughout the term of the Repo (ii) In relation to the Interest Coupons, whether or why ANTS accounted for them as income in its income statement throughout the Repo term despite them having been assigned to Santander and (iii) How ANTS would account for the FRNs and Interest Coupons on a fair value basis.

The continued recognition of the FRNs.

29. According to Ms Baird's expert accounting evidence ANTS recognised the FRNs as financial assets on its balance sheet because there had been no assignment of the FRNs themselves. (This seemed obvious to the Tribunal and to Ms Baird but she had been asked to include a response to this question in her witness statement).

The recognition of the Interest Coupons.

30. Ms Baird explained that ANTS' financial statements did not disclose the income statement and therefore she had relied on the Deloitte Accounting Letter and the Ariel Approvals Paper to conclude that ANTS had continued to recognise the Interest Coupons for the life of the Repo.

31. Ms Baird explained the accounting logic which was applied in determining that the Interest Coupons remained recognised in ANTS' accounts. She confirmed that what was recognised was not an amount equivalent to those Interest Coupons but was actually the Interest Coupons themselves.

32. The FRNs and the Interest Coupons were treated as separate assets for accounting purposes. ANTS retained the contractual right to receive the Interest Coupons under the Repo but did not retain the benefit of that interest because of its contractual obligations to pay the amounts to Santander, so a transfer had occurred under paragraph 19 of IAS 39.

33. However, under IAS 39 paragraph 20 the test for derecognition was not met because ANTS still had the risks and rewards of the interest income as a result of the Cross Options (the put and call options which made up the return leg of the Repo). Ms Baird described this test as essentially a test of substance over form which requires derecognition only if substantially all the risks and rewards of ownership have been transferred. In this case, if interest rates went up, ANTS would exercise its call option, if interest rates went down, Santander would exercise its put option. If there was no change in interest rates, neither party would exercise their option and the Repo would run to term. In Ms Baird's words:

> *"The calculation of the option strike price ensured that ANTS retained the risks and rewards of ownership of the interest receivable on the FRNs during the Deed [Repo] term*"

34. Despite the fact that if interest rates stayed the same neither party would have any economic incentive to exercise their option, it was nevertheless her view that

ANTS should be treated as exposed to the risks and rewards of the ownership of the Interest Coupons. ANTS had retained the exposure to the variability in the present value of the future net cash flows from the financial asset in accordance with IAS 39 paragraph 21: *"An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer"*.

35. In economic substance and for accounting purposes the Repo was treated as giving rise to a secured loan and this went hand in hand with the continued recognition of the Interest Coupons by ANTS.

36. Mr Prosser asked Ms Baird whether her accounting analysis was consistent with the analysis applied by the accounting expert (Mr Holgate) in the *DCC Holdings* case and how, if a legal transfer to Santander was recognised, interest for the period of the legal assignment would be apportioned. Ms Baird's response was that in theory interest would be apportioned for the period to which the a party was legally entitled to it, but she emphasised that in the Ariel transaction the terms of the Repo applied to interest for the period from 1 January to 13 July, not just during the Repo term (from 9 March).

The application of fair value to the FRNs and the interest income.

37. ANTS had to account for fair value gains and losses on the FRNs as well as the Interest Coupons. The interest income was calculated using the effective interest method. ANTS included both the fair value gains and losses and interest income on the FRNs within one category of income within its income statement.

Arguments for ANTS.

38. ANTS' position is that despite the Interest Coupons arising on the FRNs being recognised in its accounts under GAAP during the Repo period, it would be counter to the provisions of the corporation tax acts and the loan relationship code to include that amount as a taxable credit under s 84 Finance Act 1996. This is because:

The Interest Coupons do not belong to ANTS during the Repo term.

39. For corporation tax purposes a company can only be charged to tax on profits which are its own profits as a matter of fact and law. Similarly, s 84(1)(a) Finance Act 1996 applies to profits of a company; the interest arising on the FRNs was not, for the Repo period, ANTS' property arising from its loan relationships. A credit can only be brought into account under s 84 if it arises from a loan relationship of the company whose tax liability is to be determined; the Interest Coupons did not, during the term of the Repo, arise to ANTS from a loan relationship or represent interest belonging to ANTS under any loan relationship to which ANTS was a party. During the term of the Repo ANTS was not entitled to the interest payable on the FRNs and there was no argument that the Interest Coupon payments themselves could be treated as a loan

relationship. The credit was therefore not taxable under s 84(1)(b) Finance Act 1996 as interest arising under a loan relationship.

40. The credit did not fall within s 84(1)(a) Finance Act 1996 either because the accounting credit in ANTS' income statement arose not under a loan relationship, but because ANTS had sold the Interest Coupons. From a legal perspective the profit which ANTS had derived from assigning rights to the Interest Coupons on its loan relationships (the FRNs) was the Repo Purchase Price, which Mr Prosser described as being the capitalisation in ANTS' hands of the right to interest but not itself a payment of interest. However, that sum could not be treated as creating a credit under s 84 because although it arose from a disposal of rights under s 84(5) it arose from a transaction (the Repo) which was specifically excluded from being treated as a related transaction giving rise to taxable credits by paragraph 15(1) Schedule 9 Finance Act 1996.

The accounting treatment looks to substance not legal form.

41. Mr Prosser referred to the statement of Norris J in the *DCC Holdings* (High Court decision) at paragraph 31 that "*the statute [the loan relationship code] does not adopt accounting practice"* and deduced that it should not be surprising that in this case the tax treatment does not follow ANTS' accounting treatment. The accounting rules require the transaction to be treated according to its substance (as a secured loan) and ANTS is treated as continuing to hold the Interest Coupons on the FRNs for that reason, but the loan relationship code does not look at the substance of the transaction in this way. The accounting analysis of treating the Repo as a secured loan goes hand in hand with ANTS not being treated as having sold the Interest Coupons, but neither of those aspects of the accounting treatment reflect legal reality or the approach of the loan relationship code.

42. The loan relationship code is based on legal concepts and in this instance there has been a legal transfer of the Interest Coupons. Mr Prosser stressed that the loan relationship code at paragraph 15 of Schedule 9 Finance Act 1996 does not deny that a transfer has occurred, but only that it should not be treated as a related transaction giving rise to credits. The Interest Coupons are not security for any loan relationship (under s 81(5) Finance Act 1996) and the fact that the right to receive the interest has been transferred is recognised as a legal disposal of rights (under s 84(5) Finance Act 1996) but is then ignored as a result of paragraph 15 of Schedule 9. It is this legal analysis which is paramount for the loan relationship code in the Finance Act 1996 and the fact that the accounting treatment provides a different answer does not mean that these sums should be brought into account.

43. The result of this analysis is that ANTS is taxable neither on the interest income to which it is treated as entitled to for accounting purposes (because that is an accounting and not a legal recognition and falls outside both s 84(1)(a) and (b) Finance Act 1996) nor on the purchase price which it actually receives (because that arises from a transaction which cannot be taken account of under the loan relationship code). This is the inevitable and unsurprising result of paragraph 15(1) of Schedule 9 applying to the sale of the Interest Coupons. Mr Prosser considered the history of the

drafting changes to paragraph 15 and concluded that the purpose of the relevant current version was to exclude debits or credits from the disposal of a loan relationship as part of a repo transaction being brought into account. In his view, HMRC are wrong to suggest that paragraph 15(1) means that the repo transaction itself is ignored; it is only the debits and credits arising from that disposal which are ignored. Mr Prosser could not however suggest a clear explanation for the intended application of paragraph 15(4A) of Schedule 9, which suggested that ANTS should still be treated as a party to the loan relationship despite the Repo, which he described as a "*riddle inside a conundrum wrapped in a puzzle*". According to Mr Prosser it is not legitimate to approach these rules assuming that because the Repo Purchase Price is not taxed at all, the amounts representing the Interest Coupons should therefore be taxed.

DCC Holdings and symmetry.

44. In Mr Prosser's view, any arguments as to symmetry as set out by Lord Walker in the *DCC Holdings* (Supreme Court decision) go not to symmetry as between the two parties to the repo (here ANTS and Santander) but to the symmetry of debits and credits for the borrower as between loan relationship credits and debits and taxable income arising under s 737A and s 730A Taxes Act 1988 which bring into tax the price differential on the sale and repurchase of securities and are not relevant here. The symmetry in question is not a symmetry between the position of ANTS and Santander in their tax payments therefore there is no need to consider the position of Santander at all; the debtor side of the loan relationship does not inform the credit analysis for ANTS in this case.

ANTS' secondary argument

45. Mr Prosser submitted that if the Tribunal did not find in ANTS' favour on the points above and treated the Interest Coupons as giving rise to taxable credits for the purpose of the loan relationship code, the amount on which ANTS should be taxable was not the whole amount of the Interest Coupons sold, but only the amount of interest accruing to ANTS outside the Repo period, estimated to be approximately 40% of the total coupons subject to the Repo on a daily time apportionment basis.

46. ANTS' starting position was that the decision in *DCC Holdings* had no relevance to this case, but as a secondary argument Mr Prosser relied on the "simple time apportionment" on an accruals basis applied by Lord Walker in the Supreme Court decision. The logic of Lord Walker's conclusions on the so called "credit" issue was that the accruals basis of accounting should apply to both parties to the repo to tax them on the amount of interest arising only for the time which they had a right to the interest (either directly or as a result of holding the securities under the repo). By reference in particular to the expert evidence given to the Special Commissioners:

> "*The accrued proportion of the coupon on the gilts based on the period of the repo transaction if it is assumed that the related transaction occurred but the*

debits and credits arising are ignored and the legal ownership of the gilts is accounted for" [paragraph 66 of *DCC Holdings* SCD decision]

47. In those circumstances the bank was only treated as receiving taxable interest coupons for the period while the gilts were not subject to the repo, the "non repo element of the interest" in Mr Prosser's words. This approach was consistent with the legal analysis that a sale of the Interest Coupons had occurred. In ANTS' case this meant that it should only be subject to tax on the interest arising for the period when the Interest Coupons were not subject to the Repo (from 1 January to 9 March 2007 and from 2 July to 13 July).

Arguments for HMRC

48. HMRC's submissions were relatively brief, relying on the relevant then current version of s 84 Finance Act 1996 and accepting that this had picked up the approach of Moses LJ and Rix LJ in the *DCC Holdings,* Court of Appeal decision, Mr Milne submitted that there is a two pronged test to determine whether credits are brought into account for the loan relationship code; starting first with the accounting test and then asking if the credits provided by the accounts fairly represent the profits arising to the party from its loan relationships.

49. In Mr Milne's view the decisions in *DCC Holdings* were not relevant, unlike in that case Santander was not a party to a loan relationship and none of the specific repo provisions in s 737A and 730A Taxes Act 1988 were in point and in any event the relevant legislation (the loan relationship rules) had changed since the *DCC Holdings* transaction was carried out (in 2001).

The accounting credits fairly represent ANTS' profits.

50. In Mr Milne's view the accounting treatment of the Repo transaction for ANTS does produce a fair representation of the profits arising from this transaction either as interest arising under ANTS' loan relationships (the FRNs) under s 84(1)(b) Finance Act 1996 (HMRC's preferred view) or as a profit or gain arising from ANTS' loan relationships (the FRNs) under s 84(1)(a). The credit recognised in ANTS' accounts does arise from its loan relationships; it is recognising interest from its loan relationships, the FRNs which continue to be held by ANTS. Mr Milne stressed, as had been confirmed by Ms Baird, that it is the Interest Coupons themselves, not payments representing the Interest Coupons that the accounting analysis recognises. The accounting treatment applied is in line with reality since it takes account of the Cross Options with the result that ANTS is treated as still exposed to the risks and rewards of the Interest Coupons.

51. The statutory question posed by s 84 is whether the amounts recognised in ANTS' accounts fairly represent profits arising on ANTS' loan relationships, the statutory question is not "have amounts to which ANTS is not entitled been brought

into account", as suggested by Mr Prosser. The Interest Coupons which are recognised in ANTS' income statement are not profits from a related transaction (the Repo), the profits arising from that are represented by the Repo Purchase Price, which is not recognised. The Interest Coupons are profits from the loan relationships themselves and as made clear by Ms Baird, they reflect the interest paid on those loan relationships.

Paragraph 15, Schedule 9.

52. According to Mr Milne, there is nothing in paragraph 15 Schedule 9 Finance Act 1996 which disturbs this conclusion. The approach of paragraph 15 is consistent with the accounting approach in this case. It is clear, and was made clear in *DCC Holdings*, that the paragraph 15 provisions do not say that the Repo did not occur; only that it should not be treated as a related transaction for the purpose of the loan relationship code. The aim of paragraph 15 is to prevent double taxation (here, on the Repo Purchase Price, which is kept out of account and on the Interest Coupons themselves, which are recognised by ANTS) by providing that a repo transaction is ignored for determining the relevant parties' rights under the loan relationship which is the subject of the repo transaction. Here ANTS has not recognised the Repo Purchase Price in its income statement, but has recognised the Interest Coupons arising from its loan relationships (the FRNs). All that paragraph 15 does is to say that the Repo is not a related transaction and no more. It prevents double taxation rather than making corporation tax voluntary as ANTS's approach seeks to do.

53. Paragraph 15 is intended to apply in circumstances where there has been a repo of securities plus interest coupons and s 730A and 737A Taxes Act 1988 are in point, generating deemed interest payments by reference to the repurchase price of the repo. Those provisions are not in point here. Reference to the specific purpose of these provisions in reliance on any of the *DCC Holdings* decisions is not appropriate because those decisions dealt with earlier versions of the loan relationship legislation; the DCC repo was carried out in 2001.

54. Mr Milne accepted that the application of paragraph 15(4A) Schedule 9 Finance Act 1996 was oblique but said oblique or not, it was not relevant to these circumstances because it does not apply when s 730A and s737A were not in point. There is no question here of needing to decide whether the transferee is party to a loan relationship, it has been accepted by both parties that Santander is not party to a loan relationship as a result of the Repo.

DCC Holdings & the need for symmetry.

55. Mr Milne suggested that references to *DCC Holdings* and an approach which is not in line with accounting practice is misconceived in this instance because that case referred to an earlier iteration of the legislation in which the predominance of the accounting treatment was less clear. In his view nothing in the Supreme Court decision in *DCC Holdings* undermined the fundamental approach of Rix LJ and Moses LJ in the Court of Appeal, Lord Walker merely had a different view of what

was a fair representation of the company's profits in that case. However, symmetry is the fundamental issue here and ANTS' interpretation of the legislation leads to an asymmetrical result. Lord Walker's general observation about the need for symmetry is relevant despite these different facts: *"in my opinion the need for a symmetrical solution lies at the heart of this appeal". [Paragraph 26 of DCC Holdings Supreme Court decision]*. ANTS' arguments result in neither ANTS nor Santander (had it been resident in the UK) bearing tax on the coupons and that is not a symmetrical solution.

56. Mr Prosser's suggestion of applying an apportionment approach to this transaction in reliance on *DCC Holdings* is not appropriate because Santander is not party to a loan relationship, it is just making a commercial turn on lending an amount to ANTS.

Decision

*Facts Found***:**

(1) The Repo was structured as a transfer plus re-sale through the exercise of either a put or a call option. The put and call options, the Cross Options were the return leg of the repo without which there would not have been a sale and repurchase agreement at all. (In this way the Ariel repo differed from the more usual form of repo in which the repurchase would have been by way of a simple re-acquisition).

(2) The pricing of the put and call options over the FRN Interest Coupons was such that if interest rates increased, ANTS would re-purchase the Interest Coupons. If interest rates decreased, Santander would put the Interest Coupons back to ANTS. Either the put or the call would always be exercised on a change in the Euribor rate.

General Comments

Repos are difficult.

57. The question of who should properly bear tax on the interest arising on securities which are the subject of a sale and repurchase transaction during the term of that repo is problematic for the UK tax code. In practice income arising during a repo term will usually be factored into the repurchase price of the repo and therefore the UK tax legislation introduced, in s 730A and 737A Taxes Act 1988, complex rules to determine the taxing rights between the repo parties to ensure as far as possible that the tax followed the recipient of the income.

58. The complexity of the UK legislation has been compounded by the introduction of tax legislation, the loan relationship rules, which take as their primary reference point the accounting treatment of transactions within their ambit. The accounting treatment of repo transactions is radically different from that envisaged by the legal treatment reflected in s 730A and s 737A. The repo legislation and the *DCC Holdings* case can be viewed as a debate about where the boundaries between the accounting

and legal approaches to taxing these transactions should be. By the time of the Ariel transactions the boundaries had been re-drawn in the shape of s 84(1), 85A and B and Schedule 9 of Finance Act 1996.

59. The complexity of those rules is well demonstrated by the *DCC Holdings* case which took many years of litigation and was heard by four different courts each coming to a slightly different conclusion as to the right tax result. That case was cited extensively to us despite the fact that it concerned a transaction with rather different facts and an earlier iteration of the legislation which has undergone a significant number of re-drafts in an attempt to deal with repo transactions before and after the legislation which is relevant to the Ariel transaction.

Approach of the loan relationship code.

60. As stated in *DCC Holdings* before the Special Commissioners, accepted by Court of Appeal and as reflected in the relevant version of s 84 Finance Act 1996, the underlying assumption of the loan relationship code is that the accounting treatment of debt transactions will provide the primary basis on which a company should be subject to tax in relation to profits and gains arising from its loan relationships. Our view is that this is made clear in the drafting of s 84(1), s 85A and B and a straightforward reading of the relevant provisions supports this approach: s 85A(1)

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

61. It is also worth saying at this stage that the aim of accounting standards is to produce a "true and fair view" of a company's profits and it seems reasonable to assume that in most cases there will be a significant if not a complete overlap between what the accountant's conclusion as to a true and fair view of a transactions is and a lawyer's view of a fair representation of a company's profits. The two do not operate in parallel universes; the accounting and legal approaches have a complementary aim to provide a fair view of the company's taxable profits or losses.

62. However the tax legislation accepts that in an interface between legal and accounting concepts there could be some tension, as was seen very clearly in *DCC Holdings*, and so provides an override or safeguard, by providing that one first looks at the result produced by the accounting analysis and then considers whether that represents a fair representation of the profits or losses generated by the transaction. This process was described in the Special Commissioner's first instance decision in *DCC Holdings* as

> "*an exercise to determine which of the sums arising from the .... proper accounting .....represents the legal construct of a loan relationship*". [Paragraph 89 of DCC Holdings SCD decision]

63. In this regard we agree with Mr Milne that it is not correct to start from a legal perspective with a disregard for the accounting treatment. It is necessary to start with accounting and consider whether there is any reason to override the credits provided by that approach which there will be if they manifestly do not provide a fair representation of the company's profits which should be subject to tax. Again, as stated by the Special Commissioners in *DCC Holdings*:

> "*This highlights the importance of what actually happens in those accounts and the importance of the accounting evidence but also suggests to me that where possible, and not specifically directed otherwise, one should endeavour to construe the statute so that taxable profits and losses equate to the accounting results"* [Paragraph 21 of *DCC Holdings* SCD decision]

64. On this basis we consider that it is clear that starting point in analysing these transactions has to be their accounting treatment and not any other analysis of the transaction. The starting point for a consideration of the correct tax treatment of income from a company's loan relationship is the company's accounts and it is only in relatively unusual circumstances that the tax legislation should move away from that. Unlike the circumstances of the *DCC Holdings* case, there are no deeming provisions in point here which might produce an obvious conflict between profits recognised in ANTS's accounts and a fair representation of the company's profits.

65. The accounting starting point here is that the FRN coupons are recognised by ANTS during the term of the Repo and that is because of the existence of the Cross Options and the way in which they are priced. This was made clear by Ms Baird in her witness statement

> "*The calculation of the strike price ensured that ANTS retained the risks and rewards of ownership of the interest on the FRNs during the [Option] term..... Therefore ANTS continued to account for the interest receivable and interest income during the [Option] term*".

It is the put and call options which create the Repo here (they are the buyback leg of the Repo). It is not the case that the accounting treatment is departing from reality in concluding that no transfer happened, as Mr Prosser suggested, but only that the terms of that transfer are essentially contingent or less than absolute and taking account of the Cross Options are such that in economic substance ANTS still has ownership, because it still has the economic risk of the Interest Coupons. That is the reasons why, despite recognising a transfer under IAS 39, the accounting tests for derecognition are not met here.

Do the credits arise from ANTS' loan relationships?

66. It is then necessary to consider whether there is any basis on which the accounting basis for defining taxable profits can be overridden: ANTS says there is; the fundamental terms of the loan relationship code mean that the Interest Coupons cannot be taken account of because they do not arise from loan relationships of ANTS, they arise from the Repo agreement with Santander, or the transfer of the

Interest Coupons, and it is common ground that there is nothing in that agreement which creates a loan relationship.

67. Mr Prosser attempted to argue that the sale of Interest Coupons, their transfer under the Repo had broken the link between ANTS' loan relationships and the Interest Coupons recognised in its accounts. ANTS' premise was that the relevant question is not whether the credits recognised for accounting purposes arise from a loan relationship, but whether for legal purposes there is any loan relationship to which those credits can attach having taken account of fact that Repo has occurred. Having accepted, as we do, the primacy of the accounting recognition of profits for these purposes, our views is that the question is not whether the credits should be there at all, but whether those credits arise from ANTS' loan relationships. In the terms of s 84(1) the credits are given because the true and fair accounting analysis creates them; the only question is to identify their source.

68. The correct starting point is to analyse the source of the credits in ANTS' accounts. On the basis of the expert accounting evidence the source of the payments is a combination of (i) the actual interest due to ANTS under its loan relationship (the FRNs) with Irish securitisation vehicles (it was agreed by Ms Baird that what is reflected is the actual interest, not something representing that interest) and (ii) ANTS' retention of the economic exposure to those income flows as a result of the Cross Options.

69. Mr Prosser argued that the Interest Coupons could not be brought into tax under the general head of s 84 Finance Act 1996 when the more specific exclusion at paragraph 15 of Schedule 9 had applied to the Repo. Our view is that the profits excluded by paragraph 15 are the Repo Purchase Price, since that is directly related to the disposal of the Interest Coupons and there is nothing in paragraph 15 which specifically excludes the recognition of the Interest Coupons themselves which are recognised not because of the disposal or acquisition of rights under a loan relationship but because for accounting purposes ANTS is treated as having retained its exposure to them.

70. On this basis we have concluded that the credits recognised in ANTS' income statements can properly be treated as arising, or, on Mr Prosser's narrower analysis, deriving from its loan relationships, being the FRNs of which ANTS retained ownership throughout the term of the Repo. If those profits recognised in ANTS' income statement do not arise from its loan relationships, the FRNs to which it remains a party, it is hard to see what they do arise from. We do not consider that it is an adequate answer to this question that they arise from an accounting fiction (the existence of a secured loan) as Mr Prosser suggested. Whatever that accounting fiction might be, that will be accepted by the loan relationship code as long as this does not result in a distorted or unfair view of ANTS' profits. In this case it is hardly a fiction at all since the accounting analysis is closely aligned to legal and economic reality.

Fair representation of profits.

71. The next step is to apply the second criterion of s 84 Finance Act 1996, do these accounting entries

> *"fairly represent for the accounting period in question, all profits gains and losses of [ANTS] including those of a capital nature which, (disregarding interest and any charges or expenses) arise from its loan relationships and related transactions or interest under [ANTS]loan relationships*".

72. It is possible to view the debate between Mr Prosser and Mr Milne as whether the accounting analysis which reflects the economic substance of the Repo is a "fairer" reflection of ANTS' taxable profits than a legal analysis which treats the Interest Coupons as having been transferred. We accept that it is possible to have more than one "fair view" of a transaction for these purposes but on our analysis of the legislation even if the legal analysis could be said to produce a fair representation of ANTS' taxable profits arising from its loan relationships, it could only displace the accounting basis of profits if that basis could be said to be unfair (or not a fair representation) of the profits arising from this transaction.

73. According to Mr Prosser any suggestion that they do is an attempt to pull these credits into tax under s 84 Finance Act 1996 as a proxy for the real taxable amount, which is the Repo Purchase Price which has been specifically taken outside the scope of this taxing provision.

74. Mr Prosser continually referred to the Repo and resulting profits as the result of the *transfer* of the Interest Coupons, we consider this to be slightly missing the point; the Repo was made up of the transfer (for which the Euro 81 million was paid) and, from ANTS' perspective, a call option and put option which made up the repurchase leg of the Repo. The credits reflected in ANTS' income statement were triggered not by the sale of the Interest Coupons under the Repo, but by the Cross Options which meant that, for legal as well as accounting purposes, ANTS retained significant rights to the Interest Coupons.

75. It is worth noting here that a repo is widely defined for UK taxation purposes and although there is no dispute that this transaction fell within that wide definition, it could also be viewed not as a repo but as a sale plus matching options. It is the value of those options which is being brought into tax here and it would not seem fair to ascribe no value to them at all, which is essentially ANTS' argument.

76. It was the existence of this call option and matching put option which Ms Baird the accounting expert said led to the continued recognition of the coupons in ANTS' income statement. This is not merely an accounting approach; a lawyer would recognise the existence of these Cross Options and that they have some effect, indeed the Repo would not exist without them.

77. Working from the expert accounting evidence, but also in line with the legal analysis of the components of the Repo, it is the Cross Options which trigger the Interest Coupon recognition (not the transfer of the Interest Coupons as suggested by

Mr Prosser) and this, from ANTS' perspective is at least a profit or gain arising from ANTS' loan relationships (the FRNs themselves). We might not go as far as the accountants in saying that the call and put options should mean that ANTS has an immediate right to the actual Interest Coupons, but their existence does mean that ANTS has a clearly defined legal right to obtain those Interest Coupons which, because of the way the Cross Options are priced, is bound to be exercised whatever happens to the Euribor rate during the term of the Repo.

78. We consider that in posing this question under s 84 Finance Act 1996 it is necessary to take a broad view of the scheme of the loan relationship code, including taking account of the symmetry argument of Lord Walker in *DCC Holdings* Supreme Court decision that paragraph 15 of Schedule 9 takes a repo purchase price out of tax only on the assumption that that element of the repo will be taxed elsewhere (in the normal case via s 737A Taxes Act 1988); that is not the case here.

79. Only on a rather mechanistic approach to the loan relationship code is it possible to end up with a position where neither the Repo Purchase Price nor the Interest Coupons are liable to tax. This cannot fairly represent ANTS' profits or gains arising from its loan relationships. As stated by Rix LJ *"these are important words and have to be given their full effect, otherwise a result will be produced which the statute says is to be avoided"* [para 97 *DCC Holdings* Court of Appeal decision]

80. The question for the Tribunal is whether, taking account of the Cross Options, the recognition of Interest Coupons as per the income statement is a fair view of the profits arising from this transaction which should be subject to tax. By reference to our starting assumption that the accounting result should be disturbed only if this is an unfair representation of ANTS' profits for this period, we have concluded that accounting analysis should be accepted as representing a fair view of the profits arising from these transactions for ANTS.

81. HMRC put their case in the alternative, relying on either of s 84(1)(a) or (b) Finance Act 1996 to bring the accounting credits into tax. Ms Baird made it clear that the credits recognised in the accounts represented the Interest Coupons themselves, not some derivative of them. We are loathe to go as far as accepting in these circumstances that the economic substance recognised by the accounting treatment completely overrides the legal analysis of the Repo agreement under which the counterparty, Santander has some right to the Property during the term of the Repo. Our preferred analysis in the terms of s 84(1) is that the credits recognised in the accounts are not actual interest arising from a loan relationship (particularly given the very specific legal definition of interest) but are payments falling within s 84(1)(a) being profits arising from ANTS' loan relationships, namely the FRN's from which the Interest Coupons are derived.

82. As agreed between the parties we have made the assumption that the *Greene King* decision is correct and that the coupons themselves cannot be treated as a loan relationship. [*Greene King plc & Anor v Revenue and Customs Commissioners* [2014] UKUT 178 (TCC)]

What is the significance of paragraph 15?

83. As far as the significance of paragraph 15 of Schedule 9 Finance Act 1996 is concerned, there can be no argument but that the result of applying paragraph 15 is that the transfer under the Repo is ignored, and therefore the credits arising from that transfer, the Repo Purchase Price are not subject to tax. However ANTS' continual recognition of the Interest Coupons does not arise from a disposal or acquisition which paragraph 15 tells us to ignore but from ANTS' continued economic exposure to the variability in the value of the Interest Coupons which leads to their recognition for accounting purposes. Recognising these for tax and accounting purposes is in line with the underlying assumptions of paragraph 15 that the transfer and retransfer of the securities should be ignored for these purposes, to align the tax with the accounting treatment, although through a different route, as explained by Norris J in the *DCC Holdings* High Court decision at paragraph 31 "*the statute does not adopt accounting practice; it seeks to achieve the same result by a wholly different means*". We are not doing what Mr Prosser warned us against, trying to put the credits arising from the transfer into a different bucket and making them taxable; we are recognising the Interest Coupons not because of the disposal and acquisition under the Repo but because of the accounting treatment which reflects the fact that ANTS retained the economic exposure to them.

84. We agree with Mr Milne that on these facts the deeming rules of paragraph 15(4A) are not relevant and it is accepted as part of our analysis both that ANTS remains a party to the loan relationships represented by the FRNs and that Santander is not party to a loan relationship, without the need to rely on or consider the implications of that paragraph.

The symmetry argument – DCC Holdings.

85. Mr Prosser argued that symmetry as discussed in the *DCC Holdings* case was not relevant because we were not dealing with manufactured dividend rules and the symmetry considered in that case was intra-tax payer not as between the parties to the transaction. But his secondary argument did depend on a wider concept of symmetry as between the parties to the Repo with interest being taxable on the buyer or seller only during the period for which the coupons were received directly. Lord Walker referred in the Supreme Court to "*the Court of Appeal [being] right to see the overwhelming need for a symmetrical solution; that is the essential statutory function of the deemed income flows"*. [paragraph 44 *DCC Holdings* Supreme Court decision]

86. There was much debate between the parties about whether the analysis in *DCC Holdings* could be confined to the particular facts of that case and if not, how far it could be extended. We consider that, without needing to rely on *DCC Holdings*, the concept of "fairness" in s 84 does contain an element of symmetry both as between the two parties to same transaction and as between the taxpayer and HMRC so that there is both no double taxation and equally no non-taxation.

ANTS' secondary argument;

87. We need to deal with Mr Prosser's argument that if the Tribunal concluded, as it has, that ANTS does have taxable credits because of accounting recognition of the Interest Coupons, nevertheless those can only arise to ANTS for period while the Repo was not in place (i.e. for interest accruing up to 9 March 2007 and after 2 July). This is based on analysis from *DCC Holdings* case, from which aside from in this context, ANTS distanced its arguments. As set out above, the symmetry in that case is based on deemed receipts under the repo rules (s 737A and s 730A Taxes Act 1988) which look to interest receivable only during the term of the repo. No such specific provisions are relevant here, we are considering only whether any credits arise for the purposes of loan relationship code.

88. Having accepted the predominance of the accounting treatment for ANTS in this case, we cannot see any legal basis on which it is possible to make any further apportionment on basis that this is not a "fair representation" of ANTS' profits. Mr Prosser did not make any arguments as to how his suggested apportionment fulfilled that criterion. To be "fair" we would arguably have to apportion both the element of the Repo Purchase Price which relates to interest paid outside Repo period as well as Interest Coupons paid outside the Repo period; Paragraph 15(1) precludes the second half of this apportionment and therefore we can see no basis on which we can go beyond credits reflected in ANTS' accounts for this period to provide an apportionment which is more "fair" than that produced by relying on the accounting analysis of the transaction.

89. For these reasons this appeal is dismissed.

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

RACHEL SHORT
TRIBUNAL JUDGE

RELEASE DATE: 28 May 2015