[2018] UKUT 393 (TCC)

**Appeal number: UT/2017/0075**

***CORPORATION TAX – change in functional currency following reorganisation – whether relevant accounts complied with UK generally accepted accounting practice – yes – whether "exchange losses" arose – yes – whether exchange differences fairly represented losses arising to the company under Finance Act 1996, s.84(1) – yes – appeal dismissed***

**UPPER TRIBUNAL**
**TAX AND CHANCERY CHAMBER**

**THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS** — **Appellants**

**- and -**

**(1) SMITH & NEPHEW OVERSEAS LIMITED**
**(2) TP LIMITED**
**(3) SMITH & NEPHEW FINANCE HOLDINGS LIMITED** — **Respondents**

**TRIBUNAL: MR JUSTICE FANCOURT**
**JUDGE THOMAS SCOTT**

**Sitting in public at The Royal Courts of Justice, Rolls Building, Fetter Lane, London WC2 on 13 and 14 June 2018**

**James Rivett and Emma Pearce, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for HMRC**

**Julian Ghosh QC, Jonathan Bremner QC and Charles Bradley, instructed by Johnson Allen Tax, for the Respondents**

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DECISION

## Introduction

1. This is the decision on the appeal by HMRC against the decision of the First-tier Tribunal ( "FTT") in *Smith and Nephew Overseas Limited & others v Revenue and Customs Commissioners*. The FTT's decision ( "the Decision") is published at [2017] UKFTT 151 (TC).

2. Following a company reorganisation, Smith and Nephew Overseas Limited ("SN Overseas"), TP Limited ("TP") and Smith and Nephew Finance Holdings Limited ("SN Finance") (together " the S&N Companies") changed their functional currency from sterling to US dollars. They claimed in their tax returns for the accounting periods ended on 31 December 2008 that this gave rise to foreign exchange losses. In sterling terms the claimed losses amounted to £445,868,096, £138,188,096 and £90,652,234 respectively.

3. The companies claimed that the exchange losses arose as a result of revaluations included in the statement of total recognised gains and losses ("STRGL") of each of the companies in their respective accounts for the period ended 31 December 2008. The losses were said to arise as a result of the fall in the value of sterling against the US dollar.

4. HMRC did not accept that the losses arose for corporation tax purposes, and on 16 April 2014 issued closure notices under paragraph 34(2) of Schedule 18 to the Finance Act 1998 which disallowed the losses and made consequential amendments to the tax returns of each company.

5. The companies appealed to the FTT against the closure notices, and the appeals were heard together. The FTT (Judge Brooks and John Agboola) allowed the appeals, and concluded that:

> (1) The accounts of each company for the relevant year were drawn up in accordance with UK Generally Accepted Accounting Practice ("GAAP").
>
> (2) The claimed exchange differences gave rise to " exchange losses" within the meaning of the legislation.
>
> (3) Those exchange differences did "fairly represent" losses within the meaning of the legislation.

6. On 14 August 2017 HMRC applied for permission to appeal the Decision. The grounds of appeal were that the FTT had erred in law in reaching all three conclusions. In relation to the conclusion that the accounts were drawn up in accordance with GAAP, it was submitted that numerous findings of fact by the FTT gave rise to errors of law under the principles in *Edwards v Bairstow* [1956] AC 14.

7. The FTT (Judge Brooks) granted permission to appeal on all grounds.

8. At the time of hearing the appeal, the Court of Appeal had reserved its judgment in the appeal against the decision of the Upper Tribunal in *GDF Suez Teesside Ltd v HMRC* [2017] UKUT 68 (TCC). This concerned, amongst other issues, the interpretation of the "fairly represents" requirement in the loan relationships code. We determined that it was appropriate and in accordance with the overriding objective to proceed with hearing the appeal, but to allow each party to make submissions following the release of the Court of Appeal judgment on the effect if any of the decision on the "fairly represents" issue in this appeal. The Court of Appeal judgment was released on 5 October 2018. Further written submissions were received from both parties by 19 October 2018.

## The facts

9. In view of HMRC's extensive criticisms of the FTT's findings of fact in relation to the GAAP issue, which HMRC say amount to errors in law, we set out below the lengthy statement of agreed facts recorded in the Decision (at paragraph 5). The only findings of fact made by the FTT related to the issue of GAAP compliance, in particular as to the expert evidence, and we refer to those findings in our discussion of that issue. The statement of agreed facts was as follows:

> "5. The parties produced the following Statement of Agreed Facts:
>
> *The Smith & Nephew Group*
>
> (1) The Smith & Nephew Group is a multinational group engaged in the development, manufacture and marketing of medical devices. The headquarters of the Smith & Nephew Group is in the UK. The ultimate parent of the Smith & Nephew Group is Smith & Nephew PLC.
>
> (2) Smith & Nephew PLC has two main trading groups:
>
> (a) a trading group which comprises the international operations of the Smith & Nephew Group the entities within which trading group have at all material times prepared their accounts using US dollars as the functional currency and
>
> (b) a trading group "the UK sub-group" that comprised the UK trading operations of the Smith & Nephew Group which for periods prior to 23 December 2008 prepared their accounts using sterling as the functional currency including all 3 Appellants in this case.[1]
>
> (3) The First Appellant SN Overseas is a UK incorporated company which has at all material times been resident in the UK for the purposes of the UK corporation tax code.
>
> (4) The Second Appellant TP is a UK incorporated company which has at all material times been resident in the UK for the purposes of the UK corporation tax code.
>
> (5) The Third Appellant SN Finance is a company incorporated under the laws of the Cayman Islands, but has at all material times been resident in the UK for the purposes of the UK corporation tax code.
>
> (6) The abbreviation S&N is used where Smith and Nephew representatives are acting on behalf of the Smith and Nephew group as a whole or conducting negotiations in relation to a number of the Appellants and not just one individual company.

(7) Smith & Nephew Investment Holdings Limited ("SNIH") is a UK incorporated company that acts as an investment holding company for the dormant subsidiary undertakings of the Smith & Nephew Group in the United Kingdom.

5 *The inter-company position prior to 23 December 2008*

(8) At all material times prior to 23 December 2008 the Smith & Nephew Group structure was such that each of the Appellants were subsidiaries of Smith & Nephew Investment Holdings, a UK incorporated subsidiary of Smith & Nephew UK Limited, which was in
10 turn a UK incorporated subsidiary of Smith & Nephew PLC.

(9) As at 23 December 2008 the intercompany receivables were as follows ("the Intercompany Receivables");

(a) SN Overseas was entitled to an inter-company receivable of c. £1.63bn from Smith & Nephew Investment Holdings Ltd;

15 (b) TP was entitled to an inter-company receivable of c. £0.54bn from Smith & Nephew Investment Holdings Ltd; and

(c) SN Finance was entitled to an inter-company receivable of c. £0.34bn from Smith & Nephew Investment Holdings Ltd.

(10) Although non-interest bearing, the Intercompany Receivables
20 resulted in the Appellants (which were otherwise dormant) having to prepare annual tax returns reporting notional interest income arising on the Intercompany Receivables.

*The background to the transactions*

(11) On 12 November 2008, SNIH wrote to HMRC setting out a
25 proposal for waiving the Intercompany Receivables and requesting clearances to the effect that;

(a) the credits arising in SNIH and conversely the debits arising from the release of the inter-company liabilities should not be brought into account for corporation tax purposes (Para 5 Schedule 9 FA96); and

30 (b) the debt waivers should be disregarded for capital gains tax purposes.

(12) On 25 November 2008, a paper (Paper No. 1311) was prepared describing the proposed debt waivers and tabled and approved at a meeting of the Finance & Banking Committee held on that day. The
35 paper said that the debt waivers should be disregarded for all tax purposes but required that clearance to that effect should be received from HMRC.

(13) On 26 November 2008, at a meeting, HMRC refused to provide clearance to the proposal. HMRC indicated that the credits in SNIH and
40 debits arising from the release of the inter-company liabilities (including the Appellants) should be ignored for tax purposes but provided no assurance as to the capital gains tax consequences of the proposal.

(14) On 28 November 2008, S&N met PWC. S&N raised the intercompany debt issue and the reorganisation through which they
45 proposed to eliminate the loans. PWC suggested that as a result of the proposed transfer of ownership of SN Overseas and TP into the USD sub-group, substantial exchange losses would be recognised in the

dormant company accounts and that, if additional transactions were effected, it might be possible to realise a tax deduction for the exchange loss arising in the statutory accounts, this is referred to as "the PWC Proposal". The PWC Proposal required that the companies enter into a non-hedging derivative transaction to which FRS 23 applied in the financial statements for the year ended 31 December 2008. PWC suggested that on this basis it would be possible to claim that the functional currency of SN Overseas and TP should have been US Dollars with effect from 1 January 2008.

(15) On 3 December 2008, the Smith and Nephew group, Head of Financial Reporting, Mark Tompkins, produced the first draft of an accounting paper entitled the "accounting issues discussion" ('the Accounting Issues Discussion Paper') which considered the effect on the entity accounts of the functional currency change under FRS 23. This was based upon the PWC Proposal with the functional currency change supported by entering into a non-hedging derivative.

(16) On 9 December 2008, a paper was prepared for the Finance Director based on the PWC Proposal.

(17) On 10 December 2008, KPMG provided comments on the 3 December 2008 draft of the Accounting Issues Discussion Paper in connection with the PWC proposal, ultimately not a proposal implemented by the Appellants. KPMG noted in relation to the non-hedge derivative "…it is unclear what the commercial rationale for the derivative is – this may be challenged by the tax authorities."

(18) On 10 December 2008, the Smith and Nephew group, Head of Financial Reporting, Mark Tompkins, produced the second draft of the "Accounting Issues Discussion Paper' incorporating the detailed comments of KPMG.

(19) Also on 10 December 2008, SN Overseas and a representative of PWC attended a case conference with Kevin Prosser QC on the PWC Proposal. Legal Professional Privilege has been asserted in respect of this advice.

(20) On 12 December 2008, a Finance and Banking Committee presentation was prepared.

(21) On 15 December 2008, S&N emailed Chris Jackson of PWC with an attachment entitled "FRS 23 specific paper" and the comment "The attachment was an attempt to try and specifically address the FRS 23 points. I would be grateful for any additional points you might have on this which might further strengthen our argument."

(22) On 15 December 2008, PWC's Chris Jackson replied S&N with comments on the "FRS 23 specific paper".

(23) On 16 December 2008, Mark Tompkins of S&N informed the group's auditors EY that "We have received written and verbal input into the papers to support the accounting treatment and both KPMG and PWC agree with the conclusion".

(24) On 16 December 2008, S&N met EY to discuss the proposed accounting treatment to be adopted by the Appellants.

(25) On 17 December 2008, and in the context of the PWC proposal which ultimately wasn't implemented, Tim Gordon of EY emailed Nick Johnson of S&N and questioned whether it had been correct to determine the functional currency of the UK sub-group as GBP Sterling following the restructuring in 2006 which created a separate sterling denominated sub-group. Specifically, "*... if .... the decision was wrong to leave [the UK sub-group] as £ functional at the restructure I presume that this would also apply to [SNIH] which would become $ functional from the same date creating a gain that would cancel out the loss?*"

(26) On 17 December 2008, Nick Johnson of S&N responded to EY with the comment that SNIH had followed SSAP 20 throughout 2006 to 2008 and would not change its sterling functional currency.

(27) On the 18 December 2008, S&N prepared a revised accounting paper concluded that the restructuring would change the Appellants' functional currency under SSAP 20 to USD. On the same day, the final papers for the Finance and Banking Committee were prepared.

(28) On 18 December 2008, S&N wrote to EY the group's auditors for feedback on their conclusion regarding the change in the functional currency of the Appellants.

(29) On 19 December 2008, EY the group's auditors confirmed the trigger event for the change of functional currency would be the move of the entities under S&N Plc on the 23 December 2008.

(30) On 19 December 2008, a third draft of the Accounting Issues Discussion Paper was prepared after discussions with EY which did not encompass the PWC proposal. This draft of the paper reflected the accounting under SSAP 20 and was the final version approved by the Directors of the Appellants before the group restructuring that occurred on the 23 December 2008.

(31) From the 19 December 2008 to the 22 December 2008, S&N and Ashurst (Solicitors to S&N) exchanged draft versions of the legal agreements required to be implemented for the restructuring. A summary of the legal agreements was set out in an email from Tom Cartwright, Ashurst on 19 December 2009.

*The restructuring*

*The SN Overseas and TP Share Purchase Agreement of 23 December 2008*

(32) By an agreement dated 23 December 2008 between (1) Smith & Nephew PLC and (2) Smith & Nephew Investment Holdings Limited, Smith & Nephew PLC agreed to purchase from Smith & Nephew Investments Holdings Limited all of the issued share capital of SN Overseas and TP ('the SN Overseas and TP Share Purchase Agreement of 23 December 2008').

(33) Under the terms of the SN Overseas and TP Share Purchase Agreement of 23 December 2008 the consideration payable by Smith & Nephew PLC to Smith & Nephew Investment Holdings Limited was £1,659,517,000 in respect of the entire issued share capital of SN Overseas and £524,243,000 in respect of the entire issued share capital of TP which was expressed to be payable on completion in cash (Clause

2.2 of the SN Overseas and TP Share Purchase Agreement of 23 December 2008).

(34) On 23 December 2008 Sterling/US dollar swap agreements were entered into between Smith & Nephew PLC and both SN Overseas and TP to hedge the one day exposure to foreign exchange risk from holding the sterling denominated Intercompany Receivables after the functional currency changed to US dollar and until the debts were settled on the 24 December 2008.

*The SN Finance Share Purchase Agreement of 23 December 2008*

(35) By an agreement dated 23 December 2008 between (1) Smith & Nephew PLC and (2) SNIH, Smith & Nephew PLC agreed to purchase from SNIH all of the issued share capital of SN Finance ('the SN Finance Share Purchase Agreement').

(36) Under the terms of the SN Finance Share Purchase Agreement the consideration payable by Smith & Nephew PLC to SNIH was £343,955,000 in respect of the entire issued share capital of SN Finance which was expressed to be payable on completion in cash (Clause 2.2 of the SN Finance Share Purchase Agreement).

(37) Sterling/US dollar swap agreements dated 23 December 2008 between Smith & Nephew PLC and SN Finance to hedge the one day exposure to foreign exchange risk from holding a sterling denominated intercompany receivable after the functional currency changed to US dollar and until the debt was settled on the 24 December 2008.

*The TP Share Purchase Agreement of 24 December 2008*

(38) By an agreement dated 24 December 2008 between (1) Smith & Nephew PLC and (2) SN Overseas, SN Overseas agreed to purchase from Smith & Nephew PLC the entire issued share capital of TP ('the TP Share Purchase Agreement').

(39) Under the terms of the TP Share Purchase Agreement the consideration payable by SN Overseas to Smith & Nephew PLC was US$ 3,500,000,000 in respect of the entire issued share capital of TP which was required to be satisfied on completion as to (a) in cash the amount of US$ 2,444,966,000 and (b) by the issue and allotment to Smith & Nephew PLC of one ordinary share in TP at a premium equal to the balance of the consideration (Clause 2.2 of the TP Share Purchase Agreement).

(40) So far as is material the effects of the TP Share Purchase Agreement were that (1) TP became a wholly owned subsidiary of SN Overseas; (2) the amount of the premium allocated to the share in SN Overseas transferred to the share premium account of SN Overseas and (3) the net intercompany receivable in SN Overseas was reduced to $200,000.

*The Smith & Nephew USD Ltd Share Purchase Agreement of 24 December 2008*

(41) By an agreement dated 24 December 2008 between (1) TP and (2) Smith & Nephew PLC, TP agreed to purchase the entire issued share capital of Smith & Nephew USD Limited from Smith & Nephew PLC ('the Smith & Nephew USD Limited Share Purchase Agreement').

(42) Under the terms of the Smith & Nephew USD Limited Share Purchase Agreement the consideration payable by TP to Smith & Nephew PLC was US$ 3,500,000,000 in respect of the entire issued share capital of Smith & Nephew USD Limited which was required to be satisfied on completion as to (a) in cash the amount of US$ 772,367,000 and (b) by the issue and allotment to Smith & Nephew PLC of one ordinary share in TP at a premium equal to the balance of the consideration (Clause 2.2 of the Smith and Nephew USD Limited Share Purchase Agreement of 24 December 2008).

(43) So far as is material the effects of the Smith & Nephew USD Limited Share Purchase Agreement of 24 December 2008 were that (1) Smith & Nephew USD Limited became a wholly owned subsidiary of TP; (2) the amount of the premium allocated to the share in Smith & Nephew PLC in TP was transferred to the share premium account of TP and (3) the net intercompany receivable in TP was eliminated.

*The SN Finance distribution of 24 December 2008*

(44) By a resolution dated 24 December 2008 the board of directors of SN Finance resolved among other matters (i) to pay a dividend of £6,878.10 in respect of each ordinary share in issue amount to an aggregate of £343,905,000 payable to Smith & Nephew PLC as its sole shareholder ('the SN Finance Distribution'); (ii) the SN Finance Distribution was to be paid in US dollars in the aggregate amount of US$506,675,237 (using a £/US$ exchange rate of US$ 1.4733 being the spot rate payable on 23 December 2014); (iii) that the SN Finance Distribution should be paid out of share premium as to £342,903,000 in aggregate (i.e. US$ 505,198,990 at the spot rate) and paid out of profits as to £1,002,000 in aggregate (i.e. US$ 1,476,247 at the spot rate). [2]

(45) So far as is material the effect of the SN Finance Distribution was that substantially all of the intercompany receivables in SN Finance were eliminated (a balance of £54,000 remained).

*Effect of the transactions on the 24 December 2008*

(46) On 24 December 2008 the Intercompany Receivables were substantially settled (with the exception of the remaining balances of £54,000 in S&N Finance, and $200,000 in S&N Overseas).

(47) Also on the 24 December 2008 the 1 day forward contracts expired.

*The inter-company position after 24 December 2008*

(48) So far as is material the cumulative net effect of the transactions that occurred on 23 December 2008 and the 24 December 2008 was that (1) the Appellants ceased to be subsidiaries of Smith & Nephew UK Limited; (2) the Appellants became subsidiaries of Smith & Nephew PLC and (3) the Intercompany Receivables were substantially eliminated.[3]

(49) In the circumstances with effect from 23 December 2008 for accountancy purposes there was a change in the functional currency of each of (1) SN Overseas (2) TP and (3) SN Finance from sterling to US dollars.

*Events after the restructuring up to the filing of the accounts*

(50) On 8 January 2009, PWC emailed Mark Humphreys of S&N and stated that “Our total costs including our Accounting Technical input and all meetings/calls with QC etc are £34k.”

(51) Around the end of April 2009, S&N’s finance committee considered whether to record the exchange differences arising in the current reporting period from 1 January 2008 to 23 December 2008 as losses through the Profit and Loss or the Statement of Total Recognised Gains and Losses in the statutory accounts of the Appellants.

(52) On 11 May 2009, the final version of the Accounting Issues Discussion Paper was produced.

*The Appellants’ accounts for the period ended 31 December 2008*

(53) On 11 August 2009, EY provided their 2008 statutory audit letter which only applied to SN Overseas and TP of the three Appellants and it confirmed that they expected to issue an unqualified opinion and in respect of the functional currency change and that the resultant foreign exchange adjustment recognised through reserves that they concurred with the accounting treatment adopted by management.

(54) On 12 August 2009, the accounts of each Appellant were approved by the Directors.

(55) On 13 August 2009, EY signed the audit opinion in respect of SN Overseas and TP that these Appellant’s accounts gave a True and Fair view.

(56) Each Appellants functional currency changed from sterling to US dollars on 23 December 2008 and the Intercompany Receivables were denominated in sterling.

(57) On 23 December 2008 each Appellant changed functional currency to US Dollars but each Appellant still held the Intercompany Receivables but denominated in sterling which gave each Appellant a potential exposure to foreign exchange gains and losses on that day. However, each Appellant hedged any potential exposure to foreign exchange gains and losses on 23 December 2003 by entering into one day forward exchange contracts which ensured that no Appellant was exposed to foreign exchange gains or losses.

(58) Each of (1) SN Overseas (2) TP and (3) SN Finance produced statutory accounts for the accounting period ended 31 December 2008 which were prepared in US dollars.

(59) The Appellants prepared the accounts in US dollars for the accounting period ended 31 December 2008 and each Appellant recognised certain exchange differences (‘the Exchange Differences’):

(a) SN Overseas recognised an exchange difference of $877,458,000 during the period ended 31 December 2008;

(b) TP recognised an exchange difference of $271,925,000 during the period ended 31 December 2008; and

(c) SN Finance recognised an exchange difference of $178,408,000 during the period ended 31 December 2008.

(60) The Exchange Differences were not reflected in the profit and loss accounts produced by each of the Appellants for the period ended 31

December 2008 but were in each instance included within the STRGL by each Appellant and described as 'Revaluation (loss)/gain on change in functional currency'.

(61) There were no Exchange Differences reported in the Smith & Nephew Plc group accounts as a result of the restructuring.

*The Appellants' tax returns for the period ended 31 December 2008*

(62) Each Appellant prepared its tax return for the period ended 31 December 2008 on the basis that the Exchange Differences each gave rise to an 'exchange loss' within the meaning of s 103(1B) FA 1996 on the part of each Appellant which arose as a result of the movement between the US dollar and Sterling applied to the Intercompany Receivables and was recognised in each Appellants' statement of recognised gains and losses within the meaning of s 84A(3) FA 1996. For the avoidance of doubt that treatment is disputed by HMRC.

*The distributable reserves*

(63) The accounts of each Appellants under the Accounting Policies section entitled "*Change of functional currency*" disclosed the Exchange Differences in reserves as follows: "*The resulting revaluation reserve balance is recognised through the Statement of total gains and losses, and is non-distributable in nature. As a consequence of the change, the company will retain the distributable reserves and pay its dividends in US Dollars*."

(64) The Finance & Banking Committee paper no. 1322 described the restructuring proposal for SN Overseas and TP and stated "Distributable reserves – The above transactions will not result in any block in upstream intercompany dividends." In the same paper at section 1(b) it was proposed that SN Overseas would pay a dividend on 23 December 2008 of £31,989,000 as part of the restructuring transactions on the day of the local currency change.

(65) SN Overseas proposed and paid a dividend to its sole shareholder (SNIH) on the 23 December 2008.

(66) TP did not pay any dividends during the restructuring in 2008.

(67) The Finance & Banking Committee paper no. 1323 proposed in section 1(c) & 1(d) that SN Finance would pay dividends out of share premium and retained profits on 23 December 2008 as part of the restructuring transactions on the day of the local currency change.

(68) SN Finance proposed and paid a dividend of £342,903,000 from its share premium account and £1,002,000 from retained earnings to its sole shareholder, Smith and Nephew Plc, on the 23 December 2008.

(69) SN Overseas's and TP's accounts did not show any distributions between 2009 and 2013.

(70) In the year ended 31 December 2013 SN Overseas and TP carried out capital reductions.

(71) In the year ended 31 December 2013, SN Overseas carried out a capital reduction, which was agreed to by S&N Plc as sole shareholder. The reduction in share capital was set off against the foreign currency revaluation reserve loss of $818,249,000.

(72) In the year ended 31 December 2013, SN Overseas as sole shareholder of TP Limited passed a resolution to set off the foreign currency revaluation reserve loss of $253,577,000 against share premium account.

(73) The paper for the F&BC meeting which approved the capital reductions by SNO and TP Limited commented that "*the loss on the conversion of the sterling intercompany loans ... has caused a dividend trap in the chain of holding companies above SNUSD ... [which] is the largest source of distributable profit for PLC.*"

(74) In the year ended 31 December 2014, S&N Plc contributed $1,670,000,000 for one share in SN Overseas. SN Overseas contributed $1,670,000,000 for one share in TP. TP paid a dividend of £775,000,000 to SN Overseas and SN Overseas paid a distribution of $775,000,000 to S&N Plc.

*The Closure Notices*

(75) In each Closure Notice the conclusion identified by HMRC in relation to the Exchange Differences was;

(a) that the claims for non-trading loan relationship debits did not accord with UK generally accepted accounting practice; and

(b) to disallow the debits claimed in each Appellants' tax return for the accounting period ended 31 December 2008 in respect of the Exchange Differences on the basis that the Exchange Difference did not give rise to debits for the purposes of Chapter II Part IV FA 1996; and

(c) to require pursuant to para. 34(2A) schedule 18 FA 1998 certain amendments to each Appellants' tax return for later periods consequential on the disallowance of the debits claimed in each Appellants' tax return for the accounting period ended 31 December 2008.

[1] At the material time in drawing their accounts the Smith & Nephew group companies that are relevant to these proceedings applied accounting standard SSAP 20 'Foreign Currency Translation' which refers to the 'local currency' of a particular entity rather than its 'functional currency' which is the term used in more recent accounting standards (FRS 23 'the effects of changes in foreign exchange rates'). The term 'local currency' has a similar meaning as the terms 'functional currency'. For the purposes of the Statement of Agreed Facts the term 'functional currency' is used.

[2] For the purposes of these proceedings it is accepted that as a matter of the law of the Cayman Islands there was no restriction on the part of SN Finance in funding the SN Finance Distribution from its share premium account.

[3] Subject to the exception of the remaining balances of £54,000 in SN Finance, and $200,000 in SN Overseas."

## Relevant legislation

10. Unless otherwise stated all references below are to the Finance Act 1996, to the legislation in force on 31 December 2008 and to the statutory provisions so far as relevant to this appeal.

11. Section 80 introduces the loan relationship regime and sets out its exclusivity as follows:

> (1) For the purposes of corporation tax all profits and gains arising to a company from its loan relationships shall be chargeable to tax as income in accordance with this Chapter
>
> …
>
> (5) Subject to any express provision to the contrary, the amounts which in the case of any company are brought into account in accordance with this Chapter as respects any matter shall be the only amounts brought into account for the purposes of corporation tax as respects that matter.

12. Section 81(1) defines some basic terms:

> Subject to the following provisions of this section, a company has a loan relationship for the purposes of the Corporation Tax Acts wherever–
>
> (a) the company stands (whether by reference to a security or otherwise) in the position of a creditor or debtor as respects a money debt; and
>
> (b) that debt is one arising from a transaction for the lending of money;
>
> and references to a loan relationship and to a company's being a party to a loan relationship shall be construed accordingly.

13. Section 82(1) introduces the concepts of credits and debits:

> For the purposes of corporation tax–
>
> (a) the profits and gains arising from the loan relationships of a company, and
>
> (b) any deficit on a company's loan relationship,
>
> shall be computed in accordance with this section using the credits and debits given for the accounting period in question by the following provisions of this Chapter.

14. Section 84 is of particular relevance in this appeal, and provides as follows:

> (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 to the company from its loan relationships and related transactions; and
>
> (b) all interest under the company's loan relationships and all charges and expenses incurred by the company under or for the purposes of its loan relationships and related transactions.
>
> …

> (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.

15. Exchange gains and losses (the subject of this appeal) are effectively brought within the loan relationships regime by section 84A. This provides as follows:

> (1) The reference in section 84(1)(a) above to the profits, gains and losses arising to a company from its loan relationships and related transactions includes a reference to exchange gains and losses arising to the company from its loan relationships.
>
> (2) Subsection (1) above is subject to the following provisions of this section.
>
> (3) Subsection (1) does not apply to an exchange gain or loss of a company to the extent that it arises–
>
> (a) in relation to an asset or liability representing a loan relationship of the company, or
>
> (b) as a result of the translation from one currency to another of the profit or loss of part of the company's business,
>
> and is recognised in the company's statement of recognised gains and losses or statement of changes in equity.
>
> (3A) Subsection (1) does not apply to so much of an exchange gain or loss arising to a company in relation to an asset or liability representing a loan relationship of the company as falls within a description prescribed for the purpose in regulations made by the Treasury.
>
> …
>
> (8) The Treasury may by regulations make provision for or in connection with bringing into account in prescribed circumstances amounts in relation to which subsection (1) above does not, by virtue of subsection (3) or (3A) above, have effect.

16. Pausing there, subsections (2) and (3) of section 84A initially appear to preclude exchange gains and losses from being brought within the loan relationships regime (by subsection (1)) where they fall within subsection (3). However, the Exchange Gains and Losses (Bringing into Account Gains or Losses) Regulations 2002 ("the 2002 Regulations"), made under s 84A(8), have the effect of reinstating an exchange gain or loss otherwise excluded by subsection (3). Regulation 13 of the 2002 Regulations states as follows, with the effective reinstatement taking place by virtue of Regulation 13(3):

> (1) This regulation applies in the circumstances prescribed by paragraphs (2) and (2A) below.
>
> (2) The circumstances prescribed by this paragraph are where there is a disposal of an asset by a company and the asset disposed of represents a loan relationship of the company in relation to which exchange gains or losses have fallen within subsection (4) of section 84A.
>
> (2A) The circumstances prescribed by this paragraph are where there is a disposal of an asset in an accounting period beginning on or after 1st January 2005 representing a loan relationship in relation to which

exchange gains or losses were recognised in the company's statement of recognised gains and losses or statement of changes in equity.

(3) Where this regulation applies, an amount equal to the amount of any net gain or net loss shall be brought into account, for the purposes of Chapter 2, as a credit or debit (according to whether it is an amount of net gain or net loss) in respect of the loan relationship for the accounting period in which the disposal occurs.

(4) For the purposes of this regulation, the amount of any net gain or net loss shall be calculated by finding the aggregate of the amounts representing the exchange gains and losses which fell within paragraphs (2) and (2A).

17. Section 85A mandates that GAAP shall apply in determining profits and losses. For this purpose, unless a company prepares its accounts in accordance with international accounting standards, this means "UK generally accepted accounting practice", which in turn means such practice "with respect to accounts of UK companies…that are intended to give a true and fair view": section 50 Finance Act 2004. Section 85A states as follows:

(1) 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.

(2) If a company does not draw up accounts in accordance with generally accepted accounting practice ("correct accounts")–

(a) the provisions of this Chapter apply as if correct accounts had been drawn up, and

(b) the amounts referred to in this Chapter as being recognised for accounting purposes are those that would have been recognised if correct accounts had been drawn up.

18. Section 85B(1) sets out the terms on which a profit or loss is "recognised", including, as in this appeal, in a company's STRGL:

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.

19. Exchange gains and exchange losses are defined by s 103(1A) and (1B) as follows:

(1A) References in this Chapter to exchange gains or exchange losses, in the case of any company, are references respectively to—

(a) profits or gains, or

(b) losses,

which arise as a result of comparing at different times the expression in one currency of the whole or some part of the valuation put by the company in another currency on an asset or liability of the company.

5 If the result of such a comparison is that neither an exchange gain nor an exchange loss arises, then for the purposes of this Chapter an exchange gain of nil shall be taken to arise in the case of that comparison.

…

(1B) Any reference in this Chapter to an exchange gain or loss from a 10 loan relationship of a company is a reference to an exchange gain or loss arising to a company in relation to an asset or liability representing a loan relationship of the company.

## First issue: GAAP compliance

*The issue*

15 20. By virtue of section 85A, the exchange losses claimed by the S&N Companies could only be brought into account as debits under the Finance Act 1996 if such amounts were brought into account in the relevant accounts in accordance with GAAP.

21. It was agreed that the S&N Companies were obliged to change their functional 20 currency as a result of the group reorganisation summarised above. The point at issue was how to account for that change.

22. Two accounting methods were in principle available. They were the "foreign operations" method ("FO Method") and "single rate" method ("SR Method"). Under the FO Method, a company translates balance sheet amounts at the exchange rates 25 applicable at each balance sheet date, while activities during the accounting period are recorded at an average rate. Under the SR Method, all items, balances and results prior to the date of the change of functional currency are converted at the single rate applicable at that date.

23. If a company adopts the SR Method, because all relevant items are converted at 30 the date of change of functional currency, no foreign exchange differences will arise, whether gains or losses. By sharp contrast, under the FO Method, because the balance sheet items are translated at each balance sheet date, exchange differences, either gains or losses, are likely to arise, both from re-translating opening balances as between balance sheet dates and from differences between the results for the period translated 35 at average rates.

24. In this case, the adoption of the FO Method gave rise to the exchange losses recorded in the STRGL of each S&N Company. HMRC submit that the FTT erred in law in concluding that the relevant accounts of each company were drawn up in accordance with GAAP. HMRC argue that in adopting the FO Method the directors 40 of each S&N Company chose a method of accounting for the change in functional currency which was not in accordance with GAAP and that in the circumstances the SR Method was the only appropriate choice.

*The FTT's reasoning and conclusions*

25. Before the FTT, both parties relied on expert accountancy evidence. The S&N Companies relied on the evidence of Mr Peter Hogarth, the Senior Accounting Technical Partner of PwC. HMRC relied on the evidence of Mr David Chopping, a Senior Partner in the accountancy firm Moore Stephens. Both were clearly qualified and experienced in the relevant area.

26. The experts produced a Joint Report in which they set out key matters on which they agreed or disagreed, and each produced an individual report. Each gave oral evidence and was cross-examined, and questioned by the Tribunal.

27. The Decision records (at [23] and [24]) various matters on which the experts agreed. These included the following:

> (1) The legislative background to an assessment of GAAP compliance was the overarching requirement in section 226A of the Companies act 1985 for the financial statements of a company to provide a "true and fair view" of its state of affairs and profit or loss.
>
> (2) The relevant accounting standard for the year ended 31 December 2008 was SSAP 20, "Foreign currency translation".
>
> (3) SSAP 20 was silent on how to account for a change in local currency.
>
> (4) Companies ordinarily applied either the FO Method or the SR Method, "either of which may be appropriate depending on the facts and circumstances".
>
> (5) In the absence of an explicit accounting standard, FRS 18 ("Accounting policies") required the directors of the company to develop accounting policies which they judged to be the most appropriate to the company's circumstances for the purposes of giving a true and fair view.
>
> (6) The criteria against which the directors should make that FRS 18 judgment were relevance, reliability, comparability and understandability.

28. Having set out (at [27]) Mr Hogarth's description of the two methods, which was not challenged ([26]), the FTT recorded its finding that support for the FO Method could be found in guidance from the manuals of three of the "Big Four" accountancy firms, PwC, Deloitte, EY and KPMG ("the Manuals"): [28].

29. The FTT summarised the guidance in those three manuals ([29]) and accepted Mr Hogarth's proposition that while such guidance was "not authoritative" it did "describe what many accountants in those larger firms see as practice on a day-to-day basis": [30].

30. The FTT then considered the evidence of the two experts as to the four criteria to be applied by the directors in making an assessment in accordance with FRS 18. Relevance is considered at [31] to [32], reliability at [33], comparability at [34] and understandability at [35].

31. The FTT's conclusions were as follows:

> "36. Having heard and seen the examination in chief and cross examination of both expert witness we preferred the evidence of Mr Hogarth over that of Mr Chopping. Mr Hogarth was, as Mr Rivett recognised, "a fair and helpful witness" who was willing to clarify and where necessary correct errors, eg accepting that it was the Companies Act 1985 rather than the Companies Act 2006 to which he had referred to in his Report that was applicable. In contrast Mr Chopping appeared to seek to avoid giving direct answers to questions put to him in cross examination and gave the impression, contrary to the overriding duty of an expert to help the Tribunal on matters within his expertise, of seeking to argue HMRC's case, eg his contention that because of the use of the word "business" in an example in the manual, Deloitte's guidance (that the Foreign Operation Method was the preferable and most appropriate method) was applicable to only operating and not investment companies.
>
> 37. We were also concerned with Mr Chopping's reliance on KPMG's 2007-08 manual in his Supplemental Report to counter the statement in Mr Hogarth's Report in relation to the Deloitte manual. Although it would appear that his failure to refer to the 2015-16 KPMG manual, of which he was not aware, was, to adopt the language of the penalty provisions, careless rather than deliberate, we would have expected an expert witness to have been aware of the latest guidance and ensure it was brought to our attention.
>
> 38. We therefore conclude that by adopting the Foreign Operation method the accounts of SN Overseas, TP and SN Finance do comply with UK GAAP. We find support for our conclusion not only from the evidence of Mr Hogarth but also the manuals of Deloitte, PwC and KPMG and the fact that on 13 August 2009, EY signed the audit opinion in respect of SN Overseas and TP to the effect that these companies accounts gave a True and Fair view (see paragraph 5(55), above)."

*HMRC's arguments*

32. HMRC submit that the FTT "conspicuously failed to engage" with the relevant questions, instead determining the issue on the flawed bases of a "bald assertion" that they preferred Mr Hogarth's evidence to that of Mr Chopping, the supposed support in the three Manuals and the errant reliance on the EY audit opinion. HMRC's skeleton argument devotes some 25 pages to submissions on this issue. Unpicking those 25 pages, HMRC's arguments are as follows:

(1) The FTT's conclusions as regards the evidence were conclusions that no reasonable tribunal, acting judicially and properly instructed as to the relevant law, could have reached: see *Edwards v Bairstow* [1956] AC 14 at pages 29 and 36.

(2) The FTT erred in law in failing to give proper reasons for its decision: *Flannery v Halifax Estate Agencies Ltd* [1999] 1 WLR 377. In so far as reasons were given, those reasons were unsupported by the evidence, irrelevant and based on a misunderstanding of both the issues and HMRC's case.

(3) The result produced by the FO Method in this case (substantial exchange losses) was plainly inappropriate because "measured in sterling the

companies had no economic exposure to foreign exchange risk and suffered no economic loss throughout 2007 and 2008".

(4) Mr Hogarth's opinion that it was more appropriate to use the FO Method was wrong in the circumstances measured against all four FRS 18 criteria. By contrast, Mr Chopping's opinion that the SR Method was the most appropriate was correct by reference to all four criteria.

(5) It was the duty of the Tribunal to consider and reach its own conclusions on the proper accounting treatment and to give detailed reasons for those conclusions. It was an error of law for the FTT to have abrogated that responsibility by the adoption of "an unwarranted global preference" for Mr Hogarth over Mr Chopping.

(6) Where the FTT prefers one expert over another, it must give cogent reasons for that preference, and the FTT's failure to do so was an error of law: *Flannery v Halifax.*

(7) The deficiencies of the Decision are plain when compared to the detailed reasoning of the FTT in *Ball UK Holdings Ltd v HMRC* [2017] UKFTT 457(TC).

(8) The FTT erred in law in relying expressly on the contents of the Manuals, because the judgment as to the most appropriate accounting treatment depended on all the circumstances and so could not be addressed in the abstract.

(9) The FTT erred in law in relying on approval of the accounts by the company's auditors. Such approval did not necessarily establish that the accounts were GAAP compliant: see *Ball UK Holdings*.

(10) The FTT's analysis of each of the four FRS 18 criteria was wrong in law.

*S&N's arguments*

33. For the S&N Companies, Mr Bremner QC and Mr Ghosh QC made the following submissions:

(1) HMRC's appeal was fundamentally based on challenges to the FTT's findings of fact, over which the Upper Tribunal had no jurisdiction.

(2) The Upper Tribunal should exercise caution in asserting jurisdiction on the basis of challenges to findings of fact dressed up as *Edwards v Bairstow* errors of law. See, in particular, the judgment in *Georgiou v Customs and Excise Commissioners* [1996] STC 463 at 476.

(3) That caution should be even greater where, as here, the FTT has made findings of fact based on expert evidence.

(4) The FTT's findings in relation to Mr Chopping's role as an expert witness were *par excellence* findings of fact, and disclosed no error of law.

(5) Before the FTT, HMRC needed to establish not only that the SR Method would have been an acceptable method to adopt, but that the adoption by the S&N companies of the FO Method was positively non-compliant with

GAAP. For several reasons, the FTT could not properly have reached this conclusion.

(6) The submissions made in HMRC's skeleton argument reduced on analysis to the complaint that the FTT's assessment of the evidence was not the same as HMRC's.

(7) The FTT plainly did give reasons for their decision. Applying *Flannery* properly, HMRC could readily tell from the Decision why they had lost on this issue.

(8) In relation to the Manuals and to EY's audit opinion, it was proper for the FTT to take these into account in reaching their decision, and evident that they treated neither factor as determinative.

(9) HMRC's argument that the FO Method was plainly inappropriate given the absence of exposure to foreign exchange risk was flawed, because it led to the conclusion that that method could never be an appropriate method to account for a change in functional currency, and there had been no evidence to that effect.

*Discussion*

34. Section 11(1) of the Tribunals, Courts and Enforcement Act 2007 ("TCEA") provides that a party to a case before the FTT only has a right of appeal to the Upper Tribunal on a point of law arising from the FTT's decision. There cannot be an appeal on a pure question of fact which is decided by the FTT. However, a tribunal may arrive at a finding of fact in a way which discloses an error of law. That is clear from *Edwards v Bairstow* in which Lord Simonds referred to making a finding, without any evidence or upon a view of the facts which could not be supported, as involving an error of law: see page 29. In the same case, Lord Radcliffe, at page 36, regarded cases where there was no evidence to support a finding or where the evidence contradicted the finding or where the only reasonable conclusion contradicted the finding, as cases involving errors of law.

35. In relation to an appeal which is said to involve a point of law of the kind identified in *Edwards v Bairstow*, we are mindful of what was said by Evans LJ in *Georgiou v Customs and Excise Commissioners* [1996] STC 463 at 476, as follows:

> "It is right, in my judgment, to strike two cautionary notes at this stage. There is a well-recognised need for caution in permitting challenges to findings of fact on the ground that they raise this kind of question of law. That is well seen in arbitration cases and in many others. It is all too easy for a so-called question of law to become no more than a disguised attack on findings of fact which must be accepted by the courts. As this case demonstrates, it is all too easy for the appeals procedure to the High Court to be misused in this way. Secondly, the nature of the factual inquiry which an appellate court can and does undertake in a proper case is essentially different from the decision-making process which is undertaken by the tribunal of fact. The question is not, has the party upon whom rests the burden of proof established on the balance of probabilities the facts upon which he relies, but, was there evidence before the tribunal which was sufficient to support the finding which it

> made? In other words, was the finding one which the tribunal was entitled to make? Clearly, if there was no evidence, or the evidence was to the contrary effect, the tribunal was not so entitled."

36. He continued:

> "... For a question of law to arise in the circumstances, the appellant must first identify the finding which is challenged; secondly, show that it is significant in relation to the conclusion; thirdly, identify the evidence, if any, which was relevant to that finding; and fourthly, show that that finding, on the basis of that evidence, was one which the tribunal was not entitled to make. What is not permitted, in my view, is a roving selection of evidence coupled with a general assertion that the tribunal's conclusion was against the weight of the evidence and was therefore wrong. A failure to appreciate what is the correct approach accounts for much of the time and expense that was occasioned by this appeal to the High Court."

37. We consider first HMRC's assertion that the FTT failed to give reasons, or adequate reasons, for its decision. HMRC's argument that, by contrast with *Ball UK Holdings*, the FTT failed to reach independent conclusions and explain those conclusions in detail is considered in that context.

38. *Ball UK Holdings* (the appeal in which is listed to be heard before this Tribunal) does indeed demonstrate more detailed and granular reasoning than the Decision. It is likely that the FTT in *Ball* was properly mindful of the importance of setting out detailed reasons for finding that the accounts in that case were not GAAP compliant notwithstanding the views of two of the three experts and an audit opinion as to a true and fair view. In any event, we reject the proposition that in reaching a judgment based to a material degree on expert evidence the FTT makes an error of law if it does not perform for itself the same step-by-step analysis as the expert or experts, setting out in detail at every step and in exhaustive detail what Mr Rivett referred to as "its workings".

39. The duty to give reasons was considered by the Court of Appeal in the context of a judge preferring one expert over another in *Flannery v Halifax.* Henry LJ, handing down the judgment of the court, affirmed the existence of a general duty to give reasons, but stated that it was "not a useful task to attempt to make absolute rules as to the requirement for the judge to give reasons": [1999] 1 WLR 377 at page 381. As emphasised by Henry LJ, fairness dictates that the parties, especially the losing party, should be left in no doubt as to *why* they have won or lost; how that requirement is fulfilled depends on all the circumstances.

40. In this case, it would have been clear to HMRC why they lost on this issue. The FTT considered the expert evidence, the Manuals and, by reference to the expert evidence, the four FRS criteria. It then set out its conclusions, with reasons, at paragraphs [36] to [38]. HMRC patently did not agree with the conclusions or reasons, but that is a different matter.

41. Reading the Decision as a whole, we consider it is clear that on this issue the FTT was adopting the expert evidence of Mr Hogarth. It was fully entitled to do so. It is also clear that the FTT gave reasons for its decision, referring not only to the expert

evidence but also to the "support" they found for their conclusion in the Manuals and noting the EY audit opinion.

42. We do not accept that those reasons were based on inappropriate factors or evidence, or any misunderstanding of the issue. The question of whether the judgment formed by the directors of the S&N Companies was in accordance with GAAP was self-evidently an issue apt to be considered with the benefit of expert evidence. In establishing evidence of practice, the Manuals were relevant, and the FTT rightly identified them as "not authoritative". The audit opinion was relevant but (as was made clear in *Ball*) not determinative, and the FTT gave no indication that it considered otherwise. We note that HMRC did not identify other evidence or criteria which the FTT should have taken into account, and, of course, HMRC had the opportunity so to argue before the FTT.

43. We turn next to HMRC's assertion that the FTT's preference for the expert evidence of Mr Hogarth was based on a "bald assertion" and unwarranted on the evidence.

44. The FTT describes its preference for Mr Hogarth's expert evidence at [36] and [37] of the Decision. It is made explicit in these passages that the FTT had in the course of the hearing formed reservations in relation to the objectivity and expertise of Mr Chopping. Both of these qualities were critical to his role before the tribunal as an expert witness. So, far from being a bald assertion, the FTT described and justified the reasons for its preference.

45. Were those reasons, as HMRC must establish, based on irrelevant factors or no evidence, or perverse? We were taken by Mr Rivett to a considerable number of instances in the transcript of the FTT hearing, which he submitted demonstrated HMRC's case. Having considered those examples, we find HMRC's submission to be ill-founded. Indeed, the detailed exchanges between the FTT and Mr Chopping in our opinion tended to show that the FTT's concerns were not unjustified or unfounded.

46. HMRC's case in relation to the expert evidence falls well short of establishing an *Edwards v Bairstow* error of law. We also place significant weight on the fact that the FTT, which was a specialist tribunal, had the benefit of hearing, observing and questioning the two experts over an extended period. Both this Tribunal and the Court of Appeal emphasised the importance of that factor (again in relation to the FTT's assessment of expert evidence as to GAAP compliance) in *GDF Suez*.

47. HMRC submit that the FTT erred in "relying expressly" on the contents of the Manuals and on the approval of the accounts by the auditors.

48. That submission does not withstand scrutiny. We were taken through the relevant extracts from the Manuals, and from this we have concluded that the summary at [29] of the Decision was fair and reasonable. The FTT endorsed the view that while the Manuals were "not authoritative" they did describe what the relevant firms saw in practice: [30]. In "finding support" for their conclusion based on the expert evidence, the FTT were clearly not treating the Manuals as determinative. The same is true of the reference to the EY audit opinion. An audit opinion does not prove GAAP compliance (see *Ball*) but since it is evidence of a professional opinion as to the true

and fair view criterion it is relevant. The FTT was clearly correct in not ignoring or discounting as irrelevant the Manuals and the audit opinion.

49. HMRC's submission in relation to the four FRS 18 criteria proved on consideration to be an instance of the "roving selection of evidence coupled with a general assertion that the tribunal's conclusion was against the weight of the evidence and was therefore wrong" identified in *Georgiou*. The FTT considered the expert evidence in relation to all four criteria and set out the reasons for its conclusions. Mr Rivett argued that HMRC viewed reliability as the primary criterion whereas the S&N Companies wrongly viewed the primary criterion as relevance. However, that is not the issue. HMRC must establish that the FTT's reasons or conclusions in relation to FRS 18 involved an error of law, and they have failed to do so.

50. HMRC put forward a separate argument on this issue that the use of the FO Method was "plainly inappropriate" because of the absence of foreign exchange exposure for the S&N Companies as a result of the change in functional currency. We also consider this point in relation to the remaining two issues in the appeal. However, the issue before the FTT in assessing GAAP compliance was whether the accounting method chosen by the directors of each company was "in accordance with GAAP", not whether it was the best or a better method of recording foreign exchange exposure. The question of foreign exchange exposure was addressed in the expert evidence and the FTT refers explicitly to Mr Chopping's views as to the relevance of the exposure point: see [32], [33], [35]. More generally, the FTT was well aware of HMRC's arguments as to the exposure point in relation to the "exchange loss" issue: see [42]. The FTT took the point into account and addressed itself to the correct question in relation to section 85A. It made no error of law.

51. We deal finally with HMRC's argument that the FTT misdirected itself in law because it did not understand that in stipulating the use of "the most appropriate" method, FRS 18 required a binary analysis as between the two available methods, as only one of them could ever be "the most appropriate".

52. We consider this to be an unduly narrow reading of the relevant accounting standard. The starting point is the (agreed) absence of a specific accounting standard at the relevant time. Had there been one, the issue would indeed have been whether that single standard had been properly adopted. In the event, the directors were required by FRS 18 to formulate an accounting policy, and were directed to take into account four criteria in that calculation, with the explicit objective of satisfying the true and fair view requirement. It seems to us, particularly in view of the conflicting accounting evidence, that because this was a multi-factorial question of judgment and balancing several factors, more than one view might reasonably be formed as to which method was "most appropriate". HMRC did not prove before the FTT or this Tribunal that *only* the SR Method was GAAP compliant, or that no reasonable tribunal could have reached the conclusion that the FO method was GAAP compliant.

53. Even if we are wrong on that issue, the FTT in this case in fact approached and answered the question as formulated by HMRC. It did not approach the issue by a consideration of what decision the directors could reasonably have made, and whether the method chosen was GAAP compliant, but in effect by asking itself which method

was the most appropriate and preferring Mr Hogarth's evidence that in the circumstances the FO Method was more (and therefore "the most") appropriate.

54. We reach the clear conclusion that HMRC's appeal on the first issue fails.

### Second issue: exchange loss

55. HMRC appeal against the FTT's decision that the claimed exchange differences gave rise to "exchange losses".

*The issue*

56. Even if the exchange differences shown in the relevant accounts were brought into account in accordance with GAAP, they would only be treated by section 84A as loan relationship debits if they were "exchange losses". HMRC contend that the word "loss" must be interpreted in the statutory context as applying only to a "real economic" loss which is actually suffered by a company. In this case, they argue, the S&N Companies showed purely arithmetical differences in their accounts, but had no exchange rate exposure and realised no currency losses. As a result, no loss, and therefore no exchange loss, arose.

*The FTT Decision*

57. The FTT set out the competing arguments of the parties at [40] to [43] of the Decision. It concluded that Mr Ghosh's submissions for the S&N Companies were correct, stating as follows:

> "44. Given that an exchange loss is the comparison at different times of the expression in one currency of the valuation put by the company in another currency in relation to an asset we find that it must, in essence and notwithstanding Mr Rivett's submissions to the contrary, be an arithmetical exercise. We also note that the legislation does not refer to there being any exposure to exchange rates between the two dates for there to be such a loss, just a comparison at different times in one currency and then in another.
>
> 45. Such a comparison at different dates is not a novel concept. In *The Spanish Prospecting Company Limited* [1911] 1 Ch 92 Fletcher Moulton LJ considered the legal meaning of the word "profits" saying, at 98:
>
>> ""Profits" implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of a gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates."
>
> 46. Therefore, as there was a fall in the value of the assets, the Intercompany Receivables, in the present case at the second date 31 December 2008 when compared with their value as at 31 December 2007 as stated using the Foreign Operations method in what we have found to be UK GAAP compliant accounts it must follow that the Exchange Differences are exchange losses within s 103."

*Arguments of the parties*

58. HMRC submitted that in context a "loss" arose only when there was an actual or economic loss. The word "loss" must be given its ordinary meaning in the general context of the statute: see *R v Environment Secretary ex parte Spath Holme Ltd* [2001] 2 AC 349 and 379b. In *Stagecoach Group plc and another v HMRC* [2016] UKFTT 120 (TC) in the context of the loan relationship rules, the FTT focussed on the existence or absence of an actual loss. In *Union Castle Mail Steamship Co Ltd v HMRC* [2016] UKFTT 526 (TC) in the context of the rules on derivative contracts the FTT held that the taxpayer had suffered no real loss because there had been no diminution in its resources. A similar approach should apply in this case, and the FTT was wrong to distinguish *Stagecoach* and *Union Castle*.

59. In this case, argued HMRC, the exchange differences were not actual or economic losses, and this was demonstrated by a number of points. The companies had no economic exposure to foreign exchange risk and suffered no economic loss throughout 2007 and 2008. The Group revaluation reserve arising from the change in functional currency had been treated as non-distributable, showing that the exchange differences were not realised losses. SN Overseas had paid a dividend on 23 December 2009 on the basis that the differences were not realised losses. The additional share premium paid by SN Overseas and TP for the subsidiaries in the group reorganisation was effectively eliminated by capital reductions in 2013. Finally, the exchange differences were not recognised in the Group's consolidated accounts.

60. In their skeleton argument, but not at the hearing, HMRC raised a separate argument that the losses were "actively engineered" by the S&N Companies, so as to exploit a known exchange rate movement and with the clear objective of generating exchange rate differences, using an accounting policy which would produce those differences.

61. For the S&N Companies, Mr Ghosh argued that HMRC should not be permitted by this Tribunal to raise the "actively engineered" argument, as it was not pleaded before the FTT and would clearly require evidence from the relevant directors and advisers in response. In any event, he submitted, the allegation was entirely unfounded on the facts.

62. In relation to the meaning of "exchange loss", Mr Ghosh submitted that the definition in section 103(1A) was clear, and the FTT had correctly identified that it required nothing more than a comparative mathematical exercise. HMRC's proposition that a loss resulting from the comparison must also be an "actual or economic" loss derived no support from the words of section 103(1A) or the legislative context. That was not surprising in the context of a statutory scheme in which the relevant criterion was recognition of a profit or loss in the company's STRGL. Moreover, this was consistent with the normal accounting practice of translating monetary assets denominated in a foreign currency at each balance sheet date or transaction date.

63. Mr Ghosh further submitted that, in any event, the exchange losses in this case did have an actual economic impact. In particular, because of the depreciation of sterling against the US dollar, SN Overseas and TP had to raise additional amounts of

capital (by way of share premium) in order to purchase shares in the group reorganisation.

*Discussion*

64. Mr Rivett did not pursue before us the argument that the exchange losses were "actively engineered". He was right not to do so. We agree with Mr Ghosh that the FTT was the proper forum in which to take this point, because it raises primarily issues of fact. Neither party sought to challenge the lengthy statement of agreed facts set out in the Decision and recorded at [9] above, and we take that statement as fairly recording the background to and reasons for the relevant events in this appeal.

65. The question raised by this issue is one of statutory construction. The relevant legislative framework is set out at [11] to [19] above. While subsections (2) and (3) of section 84A exclude certain exchange gains and losses from the loan relationship regime, the effect of Regulation 13 of the 2002 Regulations is to reverse that exclusion in the circumstances set out in that regulation. Under Regulation 13, the aggregate of the exchange gains and losses determines the company's "net gain or net loss", which is then brought into account for corporation tax purposes as a loan relationship credit (for a net gain) or debit (for a net loss).

66. Exchange gains and losses are defined by section 103(1A) as follows:

> (1A) References in this Chapter to exchange gains or exchange losses, in the case of any company, are references respectively to—
>
> (a) profits or gains, or
>
> (b) losses,
>
> which arise as a result of comparing at different times the expression in one currency of the whole or some part of the valuation put by the company in another currency on an asset or liability of the company.
>
> If the result of such a comparison is that neither an exchange gain nor an exchange loss arises, then for the purposes of this Chapter an exchange gain of nil shall be taken to arise in the case of that comparison.

67. The wording of the definition is clear and unambiguous. It does not refer in the abstract to "profits" or "losses" in relation to foreign currency. Nor does it refer, explicitly or by implication, to profits or losses measured by reference to some other criterion such as exposure. It refers specifically to gains or losses "which arise as a result of comparing at different times" the relevant valuations.

68. It is plain that the definition requires, and in our opinion only requires, a comparison to be made at two different times. Whether the product of that comparison is or is not a "purely arithmetical difference" is irrelevant to this question. If the comparison produces a loss (or gain), then it is an exchange loss (or gain), because it "arises as a result of" the comparison mandated by the statute. The suggestion that the draftsman intended to incorporate additional unspecified criteria into the definition is precluded both by the statutory framework and the unambiguous wording of the legislation.

69. The second part of subsection (1A) demonstrates that it is the comparison which determines the existence for corporation tax purposes of an exchange gain or loss within section 84A and a net gain or net loss within the 2002 Regulations. Neither the taxpayer nor HMRC has discretion to claim that exchange gains or losses arise outside the code. If the comparison shows that in aggregate neither an exchange gain nor exchange loss arose, then the "exchange gain of nil" taken to arise is subject to the exclusivity of section 80(5).

70. The FTT was right not to be bound by the decisions in *Stagecoach* and *Union Castle*, because they concerned the loan relationships code and derivative contracts code respectively. An exchange gain or loss arises solely as a result of the comparison required by section 103(1A), subject to the safeguards found in the need for GAAP compliance and the "fairly represents" requirement. It requires no action on the part of the company or another person, and, unlike a loan relationship or derivative contract, does not relate to a bilateral agreement. Even leaving these differences aside, the decision of this Tribunal (of which Fancourt J was a member) in *The Union Castle Mail Steamship Company and the Commissioners for Revenue & Customs* [2018] UKUT 316 (TCC) illustrates the importance of construing the statutory language in its specific context. The Upper Tribunal decision, delivered after the hearing of this appeal, reversed the finding of the FTT that there was no "loss" on the basis of a detailed contextual analysis of the particular code.

71. Two further points reinforce our interpretation of exchange loss. First, the comparison applies equally to gains and losses, and in our opinion it is a sensible outcome that a taxpayer for whom the comparison produces a gain, in a situation where the relevant accounts are GAAP compliant and it is accepted that the exchange difference "fairly represents" a gain, should not be able to remove the profit from corporation tax on the basis that it is in some way not a "real" or " actual" profit, or accurately reflective of exposure. Secondly, the safeguards which HMRC seek in relation to this issue are provided by the statutory code and in the GAAP compliance and "fairly represents" requirements.

72. In view of our decision that HMRC's appeal on the second issue is dismissed for the reasons given, it is unnecessary to consider at this stage the extent to which "real" or "economic" consequences arose, but we do so below in relation to the third issue.

**Third issue: "fairly represents"**

73. HMRC appeal against the FTT's decision that the exchange losses did "fairly represent" losses of the Companies.

*The issue*

74. The relevant accounts of the S&N Companies were prepared in accordance with GAAP, and the relevant losses were "exchange losses". However, section 84(1) (set out at [14] above) further stipulates that the credits and debits to be brought into account in respect of a company's loan relationships shall be "the sums which, when taken together, fairly represent, for the accounting period in question…all profits, gains and losses of the company…which arise to the company from its loan relationships and related transactions".

75. HMRC argue that the FTT was wrong to conclude that the losses in this case did "fairly represent" losses of the company, because the companies had no underlying foreign exchange exposure and suffered no real economic loss.

*Discussion*

5 76. As set out at [8] above, at the time of hearing this appeal the Court of Appeal had not yet handed down its judgment in *GDF Suez*. That decision was released on 5 October 2018 and is reported at [2018] EWCA Civ 2075. Our discussion of this issue takes account of the submissions which we allowed the parties to make, and which they did make, following the release of the decision.

10 77. The meaning and effect of the words "fairly represent" have been considered in several cases. None of the decisions concerns the phrase as used in the context of the foreign exchange provisions in issue in this appeal, though section 84A(1) assimilates them to the loan relationships code in the Finance Act 1996, as amended.

78. In *Commissioners for Revenue & Customs v DCC Holdings (UK) Limited* [2010] 15 UKSC 58, the Supreme Court considered the test in relation to a purchase and sale (or repo) of gilts. In its decision to restrict the deduction claimed by the taxpayer, the Supreme Court referred to the absurdity of the asymmetrical result which would otherwise arise, and emphasised that "the need for a symmetrical solution lies at the heart of this appeal": see paragraph [26] of the judgment.

20 79. In *Greene King plc and anor v Commissioners for Revenue &Customs* [2016] EWCA Civ 782, the Court of Appeal dealt with the test as one of several issues in relation to a marketed tax avoidance scheme, which sought to exploit the loan relationship rules. The taxpayer in that case sought to avoid a charge to corporation tax on a loan relationship credit on the basis that it did not fairly represent a profit 25 because "it was not a profit or gain in any meaningful sense": [35] of the decision. The Court, referring to *DCC Holdings*, rejected the taxpayer's argument, partly due to lack of evidence.

80. We turn now to *GDF Suez*. The judgment is, of course, binding on us for what it decides. In its analysis of the "fairly represents" issue, the Court considered it essential 30 to note at the outset that the version of section 84(1) considered in *DCC Holdings* and *Greene King* was that in force before the amendments made by the Finance Acts 2004 and 2006: see paragraph [74] of the decision. Given the Court's conclusion that the legislative history was of material importance in interpreting the provision, we should be cautious in simply reading across what was said on the issue in *DCC Holdings* and 35 *Greene King*, given that this appeal concerns the same (amended) version of section 84(1) as in *GDF Suez*.

81. We consider that three propositions of general application can be drawn from *GDF Suez* in interpreting the "fairly represents" requirement of section 84(1) as it stood following 2006. They are as follows:

40 (1) First, particularly in view of the legislative history, it is intended to operate as an override. In 2006 the GAAP requirement of section 85A was amended so that it came to read "[S]ubject to the provisions of this Chapter

(including, in particular, section 84(1))…". The Court concluded, having taken into account the Government's Explanatory Notes to the amendment, that the purpose of this change was to address the mischief of tax avoidance schemes. It did this by "making it absolutely clear that the "fairly represents" rule in section 84(1) takes priority over, and may override, the accounting treatment mandated by section 85A(1)": [50] of the decision. It therefore imposes a separate and additional requirement for recognition of profits and losses: [88] to [91] of the decision.

(2) Secondly, section 84(1) is not limited in its purpose or effect to attribution or allocation of gains and losses to accounting periods or to loan relationships and related transactions: see [92] of the decision.

(3) Thirdly, the absence of specific statutory guidance as to the test need not be problematic. In responding to a submission by Mr Ghosh (who also represented the taxpayer in *GDF Suez*) the Court stated:

> "93. The objection that Parliament would have formulated specific guidance on the application of the fair representation test, if it was intended to be an overriding requirement of a substantive nature, is at first sight more compelling, particularly when it is remembered that the test was until 2004 explicitly linked to "an authorised accounting method". Nevertheless, I do not think that the objection is well-founded, although it was persuasively advanced by Mr Ghosh. 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. In itself, the concept needs no elucidation, but rather provides a touchstone which is well suited to application by accountants, lawyers and judges, bringing their professional experience and expertise to bear in widely differing factual contexts".

82. We turn now to the FTT's decision on this issue. It is set out in the Decision as follows:

> "50. We therefore agree with the [FTT] in *Union Castle*…that the words "fairly represent" have been included in the legislation for an identification and/or timing purpose to identify from entries in the accounts those credits or debits which arise, in that case from derivatives and [in] the present case a company's loan relationships, and which entries are appropriate in a particular accounting period.
>
> 51. Accordingly, we find that the Exchange Differences do "fairly represent" a loss arising to the appellants, as defined by s 84(1), during the period ending 31 December 2008."

83. Regardless of the Court of Appeal's decision in *GDF Suez*, we would not have found the FTT's reasoning to be correct. This Tribunal had rejected the limited attribution/timing proposition in *Union Castle*, at paragraph [47] of that decision, before the release of the *GDF Suez* decision. As the second proposition set out above makes clear, section 84(1) is not so restricted.

84. The FTT therefore erred in law in basing its conclusion on this reasoning. That does not, however, mean that we must set aside the Decision on this issue. Section 12

TCEA states that we *may* set it aside. We need not set it aside if we conclude that, notwithstanding the error of law in its reasoning, the FTT reached the correct conclusion on the issue.

85. In their submissions following the release of *GDF Suez*, HMRC argued as follows:

(1) The decision means that the test of fair representation requires an assessment of whether a loss arose as a matter of fact or general principle.

(2) Applying that approach, there was no real loss because there was no economic exposure to foreign exchange movements during 2007 or 2008.

(3) Similarly, there was no real loss because the exchange differences were not "realised" losses but merely "presentational losses arising on re-calibration". This was reflected in the treatment of distributable reserves in relation to the dividend paid by S&N Overseas in December 2008.

(4) There was a mismatch because the exchange differences were not recognised in the S&N group's consolidated accounts, providing another reason why the differences did not fairly represent losses.

(5) The wider context suggested there was no real loss. In particular, the transactions were entirely intra-group, and the share premium issued as part consideration was subsequently reduced by a capital reorganisation.

(6) The section 84(1) override "should operate to address anomalies that arise as a result of the accountancy treatment and/or the mechanical operation of the statutory regime".

86. Counsel for the S&N Companies submitted that *GDF Suez* did not have the effect put forward by HMRC, for the following reasons:

(1) The appreciation of the US dollar against sterling had a real commercial impact on the companies, irrespective of the accounting treatment, in the amount of the additional share premium payable by S&N Overseas.

(2) The adoption of the FO Method reflected economic and commercial reality.

(3) The recognition of exchange losses followed from the fact that Parliament had mandated that a foreign exchange loss must be measured by reference to valuations at two dates. It is irrelevant whether the loss has been realised. Further, Regulation 13(3) specifically requires that an amount equal to the net loss be brought into account as a loan relationship debit.

(4) GDF Suez seemingly restricts the role of the "fairly represents" mechanism to tax avoidance cases. This is not such a case.

87. In considering the third issue in this appeal, we draw guidance from *GDF Suez* in two respects. First, we bear in mind the three general propositions set out at [81] above. Secondly, while *GDF Suez* turns on its facts, it does serve to give a clear indication of the most significant factors to which a court is likely to give weight when considering all the circumstances and determining whether to apply the override. We

identify the following factors as significant in the decision by the Court of Appeal to apply the override in order to bring the credit on disposal in that case into account:

(1) The case concerned a tax avoidance scheme.

(2) The effectiveness of that scheme was, if not counteracted by the override, clearly contrary to Parliamentary intention: see [96] and [99] of the decision.

(3) Taxing the credit avoided asymmetry for tax and accounting purposes between transferor and transferee: [96].

(4) Without an override, the claims would fall out of charge to tax altogether: [96].

(5) The transferor could fairly be regarded as having made a profit or gain on the disposal: [97].

(6) On the facts, the requirement to apply the override was obvious ("the proof of the pudding is in the eating of it"): [95].

88. The facts of this appeal are very different from those in *GDF Suez*. First, this case does not concern a tax avoidance scheme. Indeed, no tax avoidance motive on the part of the S&N Companies was alleged or found on the facts. While we reject Mr Ghosh's proposition that *GDF Suez* can be taken as authority that the override can only ever apply in a tax avoidance situation, we do consider that the presence of a tax avoidance motive on the part of a taxpayer is likely in practice to be the paradigm situation in which it may be justified (depending on all the facts and circumstances) to apply the section 84 override. Such an approach is in our view borne out by the weight placed by the Court of Appeal on the purpose of the 2006 amendment to section 85A, which was to counter the mischief of tax avoidance arrangements which sought to rely on a narrow interpretation of the override.

89. Secondly, there is in this case no accounting mismatch of the kind which arose in *GDF Suez* and *DCC Holdings*. HMRC's argument that a mismatch arose because the loss from the exchange differences was not reflected in the consolidated accounts of the group is misconceived. The group's consolidated accounts were prepared in US dollars before the group reorganisation which led to the change in functional currency of the S&N Companies, so need not have recorded the change to US dollars within a sub-group, and given that the relevant receivables were intra-group the foreign exchange exposure would in principle net out on consolidation in any event. At a broader level, the point is misconceived because an exchange gain or loss, being a product of a comparison at two different times, will not necessarily generate a "symmetrical" loss or gain in the same way as (for example) a disposal of a loan relationship.

90. Thirdly, the application of the override in this case is not required in order to avoid a result which is clearly contrary to Parliamentary intention. As described above, the regime for exchange differences mandates, in section 103(1A), the method by which foreign exchange gains and losses must be calculated. Regulation 13 then specifies that an amount equal to the net gain or loss "shall" be brought into account as a credit or debit. While we do not accept Mr Ghosh's argument that these provisions effectively preclude the application of the override, the provisions do not support the

proposition that the recognition of the losses in this case, in accordance with GAAP, is (as in *DCC Holdings* and *GDF Suez*) clearly contrary to the intention of Parliament.

91. Fourthly, the override is not a mechanism to re-open the status of the accounting method for GAAP purposes. The result produced in this case by the GAAP compliant accounts was not, in the language of *DCC Holdings*, a manifest absurdity, such that the need to apply the override was obvious.

92. HMRC raised a number of arguments to support the application of the override based on the commercial or company law consequences of the change in functional currency. We refer to them above. We have concluded that those arguments either broaden the remit of the override to an extent which is unwarranted or consist in substance of a renewed attack on the FO Method.

93. The existence of differences between the calculation for tax purposes of an exchange gain or loss and the treatment for company law purposes of that gain or loss in the calculation of distributable reserves is not necessarily an indication that the tax calculation is not a fair representation of the loan relationship gain or loss. The presence or absence of exchange exposure is, as we have explained above, not a benchmark which the comparative calculation requires or incorporates. Indeed, HMRC's arguments on this issue come very close to a submission that the FO Method can never result in a fair representation. The additional share premium issued by S&N Overseas as part consideration illustrates that the change in functional currency did have "real world" consequences. The fact that the premium may have been partially reduced five years later is nothing to the point. Finally, the fact that the transactions were intra-group is not in our opinion a reason in favour of applying the override. Gains and losses can arise within a group, and the legislation contains many detailed provisions relating to group transactions.

94. Taking into account all the facts, including but not limited to the absence of a tax avoidance motive, the absence of any material asymmetry, and the absence of an absurd result, we have concluded that the exchange losses in this case did fairly represent losses as required by the legislation.

## Disposition

95. For the reasons given, the appeal in relation to the first two issues is dismissed. In relation to the third issue, we affirm the decision of the FTT but for different reasons and accordingly the appeal on the third issue is also dismissed.

**MR JUSTICE FANCOURT**
**JUDGE THOMAS SCOTT**

**RELEASE DATE: 29 November 2018**