[2013] UKFTT 216 (TC)

TC02630

Appeal number: TC/2010/05861

Corporation Tax - Novation of swaps from transferor within the regime of FA 2002 to transferee in the same group but not yet within that regime - whether adjustments to return precluded by issue of closure notice in error - application of paragraph 28 Schedule 26 – treatment of existing accruals at the time of the novation if the novation was disregarded - secondary computational issue - Appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

BRISTOL & WEST PLC **Appellant**

-and-

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

TRIBUNAL: JUDGE HOWARD M. NOWLAN
SUSAN LOUSADA

Sitting in public at 45 Bedford Square in London on 4 to 6 March 2013

Graham Aaronson QC and James Henderson, counsel, on behalf of the Appellant

Kevin Prosser QC and James Rivett, counsel, on behalf of the Respondents

DECISION

Introduction

1. This Appeal related principally to the appropriate Corporation Tax treatment of the novation of numerous "in the money" fixed/floating interest-rate swaps made by the Appellant on 29 August 2003 to another company in the Bank of Ireland group, Bank of Ireland Business Finance Limited ("BIBF") in return for a premium of £91 million. (Nothing turns on the feature that there were approximately 220 swaps, and in the rest of this Decision, we will simply refer to the swaps as if there was only one single original swap.)

2. While the principal point in issue in this Appeal was whether paragraph 28 of Schedule 26 applied to achieve the Appellant's hoped for tax saving, we must attend first to a closure notice issue. This arises because, following the opening of an enquiry into the Appellant's accounting period ending 31 March 2004, in which HMRC was questioning the Appellant's treatment of the receipt of the £91 million as a non-taxable receipt, HMRC mistakenly issued what appeared at face value to be two closure notices, in relation to the Appellant's accounting periods ending on 31 March 2003 and 31 March 2004. After the letters in question had been sent for printing, but prior to their being posted and obviously prior to them being received by the Appellant, the chief HMRC officer dealing with the Appellant e-mailed his "opposite number" in Bank of Ireland in relation to the novation issue and indicated that the closure notices had been issued in error. This led to a series of questions as to whether or not this error precluded HMRC from challenging the treatment of the novation as they eventually sought to do.

3. So far as the principal point was concerned, both parties accepted that the swap that was novated had originally been entered into (with the Treasury and International Banking division of the Bank of Ireland) for entirely commercial hedging reasons, and that its novation had been effected in the hope of securing a tax advantage.

4. The Finance Act 2002 had replaced the swaps regime of Finance Act 1994 with a somewhat modified regime, the new regime coming into force in relation to companies for their first accounting period to commence after 1 October 2002. On 29 August 2003, the Appellant (whose accounting period had commenced on 1 April 2003) was within the new regime, whilst BIBF (whose accounting period had commenced on 1 September 2002) was not. The hope and expectation was that that mis-match (and the insertion for the first time of effectively a roll-over provision designed to disregard novations between group companies and designed to treat the two companies as one) would result in the £91 million falling out of charge in the hands of the Appellant whilst BIBF (a company taxed in relation to swaps on a "mark to market" basis) would inherit no tax liability under the novation, but simply be taxed in relation to any later rises or falls in the value of the swap on account of future movements in floating interest rates.

5. HMRC's contention in relation to the novation was that the effective rollover rule of paragraph 28 did not apply, and that the Appellant should simply be taxed on the entire £91 million. Much of that receipt related to the estimated and discounted value of the anticipated receipts under the swap in accounting periods after the current one, and therefore HMRC calculated the element of the profit properly attributable to

the Appellant's accounting period ended 31 March 2004 as approximately £23 million. The remainder, on HMRC's approach, would be taxed in later periods.

6. The third point in this Appeal was hardly contentious, though it is a point that we must address in our decision. This point was that the accounting experts to both parties were agreed that the original accounting treatment adopted by the Appellant in the period to 31 March 2004 had been wrong. Originally the entire £91 million profit had been treated as a balance sheet item, and then the portion treated as attributable to the accounting period ending on 31 March 2003 had been ascertained by effecting the apportionment between the then relevant period and later periods at 31 March 2004. That is how the £23 million referred to in the previous paragraph was calculated. We were told, however, that the correct accounting treatment was first to credit to the profit and loss account for the period the accrued profit that had already arisen as at the date of the novation, 29 August 2003. This was a figure of approximately £9.6 million. We were then told, and this was again agreed between the accounting experts to both parties, that once the £9.6 million had been credited to profit and loss, the apportionment of the reduced balance of roughly £81 million made at 31 March 2004 would apportion approximately £21 million to the 2004 period (in addition to the accrued £9.6 million) and the balance to later periods. Accordingly, by adopting what was agreed to be the proper treatment, the profit attributable to the 2004 period was increased from £23 million to roughly £30 million (i.e. £9.6 million plus £21 million).

7. The fourth point in contention was only material if the Appellant's basic contention was right to the effect that in its hands the novation should be disregarded. In this event, HMRC contended that the £9.6 million, properly carried to the profit and loss account, being the profit already accrued at the point of the novation on 29 August 2003, should be taxable in any event. This point, that was disputed by the Appellant, again depended on a proper interpretation of paragraph 28 of Schedule 26.

8. Our decisions in relation to these four points are as follows:

- Having regard to the meaning of a closure notice, namely something issued to inform the taxpayer that HMRC had completed their enquiries and indicating the conclusions, nothing that can have been construed to have served that function can be said to have been issued when a prior e-mail had informed the relevant individual in the taxpayer group that the apparent closure notices had been issued in error before the notices had been posted.
- Paragraph 28 of Schedule 26 did not apply to the novation transaction, so that the £91 million received by the Appellant was not exempt from tax.
- Adopting the correct accounting treatment, and the agreed method of calculating the element of the Appellant's profit attributable to the accounting period ending on 31 March 2004, the correct calculation was to add the accrued profit as at the date of the novation to the element of the remaining £81` million attributed to the same period as at the end of that period (namely approximately £21 million), such that the profit for the period ending 31 March 2004 was approximately £30 million.
- Were we wrong in relation to the decisions in the previous two bullet points, and were the Appellants thus right to say that the requirement to disregard the novation provided for by paragraph 28 of Schedule 26 did apply to the Appellant, this effective exemption did not apply to the profit that had in any event accrued by 29 August 2003, namely the £9.6 million, and that amount was taxable in the hands of the Appellant.

The format of the remainder of this decision

9. After a short reference to the witnesses who gave evidence in person, we will deal with each of the four points mentioned above in the order indicated above. There is no material dispute about the facts and we will therefore indicate the facts, which are only material to the first two issues, and the law, when dealing with each point. We consider that it will be clearest, particularly in relation to the main substantive point (i.e. the second issue), to summarise the contentions of the respective counsel in relation to each step in the argument, giving our conclusions on each point in turn.

10. Factual evidence was only given in relation to the closure notice issue. This evidence was given by Gavin Howard, ("Mr. Howard"), the senior HMRC officer who was the principal point of contact in relation to major tax disputes and issues with the Bank of Ireland group, in which the Appellant was a member, and Liam Boyd ("Mr. Boyd"), head of UK tax at Bank of Ireland, and the person who dealt with all major tax disputes for the group companies, including the present novation dispute.

11. It was perfectly obvious that the relationship between Mr. Howard and Mr. Boyd was good, and we accepted all their evidence. There was no material difference between either of their accounts.

12. Specialist accounting evidence was given by Mr. Colin Martin of KPMG and by Mr. Robert Harvey of HMRC.

The facts in relation to the closure notice issue

13. On 22 November 2005, HMRC gave notice of an enquiry into the Appellant's tax return for the period ending 31 March 2004, there already being an open enquiry into the return for the previous period.

14. Ignoring at this point the contentious question of precisely when the documents appearing at face value to be closure notices in relation to the enquiries into the Appellant's 2003 and 2004 returns were issued, we should refer to the various points that pre-dated the "issue". For present purposes, we simply mention that the relevant documents were issued at some time between 30 October and 6 November 2007, as we will explain below.

15. Prior to this period, the state of play was that the enquiry into the 2003 return was awaiting the outcome of an appeal to the High Court in relation to a Special Commissioners' decision involving a quite separate company, and the enquiry into the 2004 period was awaiting the Appellant's responses to various questions that had been raised by HMRC about the novation transaction. Mr. Boyd said that he would have been surprised, therefore, if closure notices had been issued in relation to the two enquiries. On 19 October, Mr. Howard had e-mailed Mr. Boyd, indicating that he was proposing to issue closure notices in relation to enquiries in relation to two other group companies, with Mr. Howard saying that he just wanted to check some figures first. No such e-mail was sent in relation to the 2003 and 2004 returns of the Appellant.

16. It was common ground that the parties (particularly Mr. Howard and Mr. Boyd) often communicated by e-mail. Letters were still used for formal communications,

where for instance numerous grounds might be mentioned in support of particular claims or defences, but it was accepted that e-mails were used for other material communications, rather than just for administrative matters.

17. On 30 October 2007, or possibly on the previous day, Mr. Howard put a document on the desk of his colleague, Mr. Gill, who was responsible for arranging for the issue of closure notices and other amendments to returns. We were shown the document, and to our eyes it was perfectly clear. The words at the top were "Action required:-" and they were followed by three separate bits of text. The first two related to two Bank of Ireland group companies (those referred to in Mr. Howard's e-mail of 19 October referred to in paragraph 15 above), and requested the issue of closure notices for two periods for each of those companies. The third bit of text then referred to the Appellant by name, and simply said "amendment to tax payments resulting from reduction in GR" (i.e. group relief) as regards the 2003 period, and an increase in group relief as regards the 2004 period.

18. On Tuesday 30 October, Mr. Gill input instructions into the computer system to issue closure notices in relation to the group companies where that was intended, and in relation to the two periods of the Appellant. We were told that this resulted in the creation of some file in HMRC's COTAX system, though we believe that until the following day, people logging on to this system were unable to see information and data inputted into the system on the same day.

19. At some time on 30 October Mr. Howard realised that an error had been made, and he sought to rectify the wrong instruction. When he had been unable to change it, he sought to change the taxpayer's address to HMRC's address in the hope that the apparent closure notices would only be sent to HMRC and not the Appellant.

20. For the reason mentioned in the second sentence in paragraph 18 above, Mr. Howard was unable to ascertain whether his "re-routing" expedient had worked, but he apparently always arrived at his office shortly after 7.00 a.m. and he then ascertained on 31 October that the address had not been changed. HMRC has entrusted the printing and then the arrangements for posting closure notices to Fujitsu, and we were told that the print run for printing off countless closure notices would have commenced at 6.00 a.m on 31 October. Nobody knew when the closure notices in relation to the Appellant's two enquiries would have been printed, and then later inserted into envelopes, but we were asked to assume that it might have been before 7.44 a.m. on 31 October. We were told however, that closure notices printed and inserted into envelopes on 31 October would not have been collected for posting by Royal Mail until Thursday 1 November. Since they were then despatched by second-class post, it was assumed that they would not have been received by the Appellant until Saturday 3 November, or possibly the following Monday or Tuesday (Tuesday being 6 November).

21. Having ascertained very early on the morning of 31 October that he could not prevent the apparent closure notices being sent to the Appellant, at 7.44 a.m. Mr. Howard sent an e-mail to Mr. Boyd saying *"I wanted to pre-warn you that 2 closure notices were today issued in error in relation to [the Appellant] for periods ended 31/3/03 and 31/3/04. We will be taking action to correct the position in due course. I'll confirm the position in writing within the next few days"*. Mr. Boyd was feeling unwell at the time, and was therefore still at home. At 8.16 a.m. he sent Mr. Howard an e-mail saying *"OK Gavin, Thanks"*.

22. HMRC then sent two letters to the Appellant, indicating how they intended to rectify matters. While we will summarise the law and the contentions of the parties below, it will be clearest to say now that HMRC's contention before us was that virtually everything said in the two letters that we will now refer to was wrong.

23. The first letter, dated 8 November, recited that *"The present position is that, albeit in error, closure notices were issued on 30 October 2007 and those notices are effective under paragraph 32(1) Schedule 18 FA 1998 marking the completion of the enquiries into the returns made by [the Appellant]."* The letter went on to suggest that the manner in which this error could be rectified would be to amend the return, pursuant to paragraph 34 of the same Schedule.

24. The following points have little to do with the contentions advanced on behalf of HMRC before us, but it is worth saying that beyond the fact that the stated date of issue on the closure notice was 31 October, not 30 October, the proposal to rely on paragraph 34 was clearly wrong. The essence of paragraphs 34(1) and 34(2) at the relevant time was that under paragraph 34(1), the taxpayer was given 30 days in which to amend its return to conform to the requirements of the closure notice, and then if the taxpayer failed to do that, under paragraph 34(2), HMRC had a further 30 days to make the same amendments. But where the closure notice had required no amendments, there were no amendments to be made, either by the taxpayer under paragraph 34(1) or HMRC under paragraph 34(2), and this proposed course was therefore manifestly wrong.

25. On 23 April 2008 HMRC wrote again to the Appellant, wrongly reciting on this occasion that *"closure notices …were sent to you on 30 October 2007"*, the letter purporting on this occasion to withdraw the closure notices under HMRC's general power of management of the tax system under section 1 of the Taxes Management Act 1970. The present limited significance of this letter was that it again conceded that closure notices had been issued, and it purported to do what HMRC conceded before us was impossible, namely to withdraw valid closure notices, the implicit acceptance at the time being that the closure notices had been valid notices.

The law in relation to closure notices

26. The only statutory provision that we need to refer to is paragraph 32(1) of Schedule 18 to the Finance Act 1998 which provides as follows:

> *"32(1) An enquiry is completed when [HMRC] by notice ("a closure notice") inform the company that they have completed their enquiry and state their conclusions. The notice takes effect when issued".*

27. Whilst there are no further material statutory provisions, we consider that the following summary reflects the correct legal position, and we believe that none of the following points were disputed by the Appellant. We consider, thus, that:

- Statute law prescribes no particular form for the issue of closure notices. It would admittedly be unusual for a closure notice to be issued by e-mail, but we accept that a valid closure notice issued in writing, including e-mail, that informed the company into whose return HMRC had been making enquiries that the enquiries had been completed, stating the conclusion of those enquiries or indicating that no adjustments were required, would be a valid closure notice.

- In accordance with the decision of the Supreme Court in the case of *Tower MCashback v. HMRC* [2011] UKSC 19, in construing a closure notice it is permissible to refer to the surrounding circumstances, and other related documentation.
- Paragraph 32 contains no requirement that a closure notice should state its date of issue, and there is no specific provision, in relation to closure notices, that indicates when a closure notice has been issued.

The contentions on behalf of the Appellant

28. It was contended on behalf of the Appellant that:

- closure notices were issued either when Mr. Gill had issued the instruction for them to be printed, or when the print-run by Fujitsu had commenced (i.e. at a time conceded by the Respondents to be before Mr. Howard had sent his 7.44 a.m. e-mail);
- Mr. Gill was a senior HMRC officer and he deliberately issued the instruction to print and post the closure notices, such that it was by deliberate action, rather than by trivial administrative error that the closure notices were issued;
- the formal issue of closure notices could not be nullified by a two-line e-mail, particularly one issued after the issue of the closure notices;
- Mr. Howard's "7.44 a.m." e-mail had itself conceded, just as the later two letters of 8 November 2007 and 23 April 2008 had conceded, that valid closure notices had been issued, and HMRC could not now dispute that. Furthermore at the times of despatch of that e-mail and those letters, HMRC had never sought to dispute that valid closure notices had been issued, albeit in error, and they had not identified any valid method of reversing the apparent effect of the issue of the closure notices; and
- since a valid closure notice had been issued in relation to HMRC's enquiries into the Appellant's return for the period ending 31 March 2004, no adjustments could now be made to that return.

The contentions on behalf of the Respondents

29. It was contended on behalf of the Respondents that:

- the date of issue of a closure notice should be ascertained by referring to the normal meaning of "issue", and by paying regard to the context in which the question had to be answered;
- when the function of a closure notice was to inform the taxpayer of something, the natural point at which to conclude that a notice had been issued was either at the point when it was despatched by the person issuing the notice to the intended recipient or at the point when it was received by that person;
- since the taxpayer was given 30 days from the issue of a closure notice under the original provision in paragraph 34(1) of Schedule 18 to make modifications to its return, it made sense to treat the time of issue as the time at which the taxpayer received the relevant notification, for otherwise the 30-day period might either expire before the taxpayer had even received the notice, or with a late-delivered notice, the period for making modifications might be very much reduced;
- nothing depended on whether the error, of which Mr. Boyd had plainly been informed prior to the issue of the formal clearance letter, was an administrative error, though it was;

- nothing turned either on whether HMRC had identified, at the time of the despatch of Mr. Howard's 7.44 a.m. e-mail, or when the letters of 8 November and 23 April were sent, how they would eventually seek to deal with the situation, and nothing turned on various confirmations that closure notices had been issued. Any such confirmations were simply wrong. Finally,
- the fundamental contention was that when the correct person in the taxpayer group dealing with the novation issue had been informed, prior to any occasion when the closure notices could sensibly be said to have been issued, that they had been issued in error, it was inappropriate to say that the taxpayer had been notified that HMRC's enquiries into the 2003 and 2004 tax returns of the Appellant had been completed. In reality, the taxpayer had been notified that a letter, to be sent, was in error, and that it should not be read at face value. Accordingly no closure notices had been issued.

Our decision on the closure notice issue

30. The decisive factor in relation to this issue is that the state of affairs, defined by paragraph 32 Schedule 18 to constitute a "closure notice" is the issue by HMRC of a notice, informing the taxpayer that HMRC have completed their enquiries, and stating their conclusions. That paraphrase rolls together the two sentences of paragraph 32.

31. As a general matter, we accept that the normal meaning of "issuing" something is to provide it, make it available, or deliver it. Accordingly our expectation, before referring to the context, is to suppose that a notice will only be issued when it is sent, or possibly received. The notion of saying that a notice in a letter has been issued when the letter has been typed or printed, and before it has been despatched, is inconsistent with the general meaning of the notion of "issue". Even if the computer and other instructions meant that a letter sent for printing was automatically the subject of an irrevocable instruction that, once printed, it should subsequently be despatched, we still conclude that on the ordinary meaning of the term "issue", the notice would not be issued until it was despatched.

32. We consider that the notion of what constitutes an issue should certainly pay regard to the context. Thus, taking an example that we mentioned in the hearing, it might be appropriate to say that a passport was issued when the document had been created, even if it was not sent to the applicant. Taking the facts of the present case, however, when the notice must be something that notifies the taxpayer of some state of affairs, the case for saying that such a notice can only be issued when the process of notification commences (or possibly when it is actually effected by receipt of the notice by the taxpayer) is absolutely compelling. We conclude, therefore, that the earliest possible date on which to say that the notice had been issued was 1 November, the date when we were told that it would have been collected for posting by the Royal Mail.

33. Addressing the question, thus, of whether on 1 November, it could be said that the Appellant had been notified that HMRC had concluded their enquiries into its 2004 tax return, the obvious and only conclusion is that the taxpayer had not been so notified. The appropriate person in the Appellant's group had been notified that a letter had been sent in error and the substance of the information was that HMRC had not completed their enquiries. Accordingly nothing that performed the function of notifying the taxpayer that the enquiries had been completed had been issued, and so no closure notice had been issued. Our conclusion might have been different if a closure notice had had to take some specific statutory form, and it was impermissible

to look at surrounding circumstances, or other indications, to construe the notice. It is however clear that there is no such "stand-alone" statutory form, and that it is permissible to look at the surrounding circumstances. When that other indication, i.e. the crucial e-mail, nullified the message contained in the closure notice letter, that e-mail entirely qualified and undermined the notice.

34. We see no relevance whatsoever to the issue of whether HMRC's error was an administrative error or not. It was certainly not a substantive error, in other words one where HMRC had initially meant to indicate that on substantive grounds they accepted the taxpayer's arguments, and then at the last second, or before the last second, the light suddenly dawned, and they decided that the novation transaction should be challenged. We have seen the instruction sent by Mr. Howard to Mr. Gill, and it is perfectly clear that Mr. Gill's error was a human error, whether understandable or not, of the same administrative character, just as if he had mistakenly pressed the "Send" button on a computer, instead of the "Delete" button. For some reason, the Appellant had conceded that its closure notice contention would not even have been raised, had the error been of that computer-type nature. We are unable to see the distinction between that type of error and the human error made in this case. But none of this matters. The decisive point is simply that, prior to the earliest point at which the notice can be said to have been issued, the Appellant had been notified that the letter that was to be issued would be issued in error. Accordingly it could not possibly be said that the Appellant had been notified that HMRC's enquiries had been completed.

35. We note that Mr. Boyd clearly understood the import of the 7.44 a.m. e-mail, insofar as the only relevant point was concerned. HMRC contended that the e-mail would still have undermined the later notice even if it had not been read or understood. HMRC also indicated that they considered it more appropriate to say that a notice was issued when actually received by the taxpayer, rather than when posted. We have no need to consider these issues. Mr. Boyd did plainly read and understand the critical e-mail. We have decided that the point of issue might be either that of despatch of the closure notice, or receipt by the taxpayer. We have no need to decide which, and clearly both were after the 7.44 a.m. e-mail had been both sent, and read and understood.

36. The decision is accordingly that on no date around 1 November 2007 were closure notices issued in relation to the 2003 and 2004 returns of the Appellant. Accordingly nothing precluded HMRC from later making the adjustments to the return occasioned by HMRC's contentions concerning the second and fourth issues below.

The application or non-application of paragraph 28 of Schedule 26 to the Finance Act 2002 to the novation effected on 29 August 2003

37. The facts in relation to the novation were simple. On 29th August 2003, the Appellant novated its in-the-money fixed-floating interest-rate swap with Bank of Ireland to BIBF. The value of the swap, and the consideration paid to the Appellant was £91 million. As already indicated, the novation was effected in the Appellant's accounting period that had commenced on 1 April 2003, such that the Appellant had passed the commencement day for the application of the provisions of Schedule 26, Finance Act 2002 to it, whilst 29th August was two days before the 31st August accounting date of BIBF, with the result that on 29th August, BIBF was not covered by the provisions in Schedule 26. The Appellant had been computing its

profits on an accruals basis, and BIBF computed its profits on the mark to market basis.

Background considerations

38. We consider that this decision will be clearest if, before dealing with either the crucial second issue or the fourth issue, we indicate briefly how we consider that the old 1994 Act provisions and the 2002 Act provisions would both have applied in relation to novations in which both parties had plainly been covered by the same provisions. We will indeed add one example in which a single company, covered by the provisions in the 2002 Act, might have switched accounting treatment, and this might have occurred during or at the end of an accounting period, from the accruals basis to the mark to market basis, without there being any novation at all.

39. We should indicate the following three points in relation to the summary that we will now give, namely that:

- the parties did not address us on the appropriate treatment when there was a switch from the accruals basis to the mark to market basis, and so our observations on this aspect are made on the basis of our understanding of the appropriate accounting treatment and the relevant provisions;
- although the summary that we will now give may be of some assistance in relation to the crucial second issue, that revolves more around points of interpretation that have little to do with whether the following summary is correct or not; and
- the summary will simply assert the way in which the provisions appear to us to be intended to operate. In relation to their application to the fourth point below, we aim to support our summary insofar as it is vital to the correct treatment of the Appellant in relation to the fourth point, when actually dealing with that point. By that stage, we will have quoted the relevant text of paragraph 28 Schedule 26 Finance Act 2002, which we will ignore in giving this initial summary.

The various examples

Both parties covered by the provisions in the 1994 Act, the transferor computing profits on the accruals basis, the transferee on the mark to market basis

40. The 1994 Act provisions contained no equivalent of the “rollover” type rule first provided by paragraph 28 Schedule 26 in the Finance Act 2002.

41. Accordingly, the **transferor** would have been taxable on the entire £91 million received (always assuming that the swap had had a nil value when entered into, with therefore no premium being paid). The £91 million would have represented both profit of the then current period at the time of the novation and for the rest of that accounting period, and anticipated profit in later years, depending on the period for which the swap provided for payments. Accordingly, the profit would be taxed in each year, on an accruals basis, roughly matching the presumed excess floating rate interest costs in relation to the borrowings and loans originally hedged by the swap.

42. In the hands of the **transferee** (taxed on the mark to market basis with an acquisition cost of £91 million), there would have been no liability unless the value of the swap actually increased, or possibly because the initial discount in the £91 million

valuation of the swap progressively unwound. Correspondingly, if the swap or the eventual payments fell in value from the initial valuation, the transferee would have secured relief for such value falls.

Both parties covered by the provisions of the 2002 Act, both computing their profits on the accruals basis

43. Had both companies been taxable under the 2002 provisions at the time of the novation, both calculating their relevant profits on the accruals basis, the rollover provision under paragraph 28 Schedule 26 Finance Act 2002 would have applied.

44. Accordingly, the position would have been that:

- the novation itself, and whatever amount (if any) had been paid by the transferee for the acquired swap, plus incidental costs, would all have been ignored;
- the transferor and the transferee would have computed the profits in respect of the swap, in all periods during the subsistence of the swap, as if they had been a single company holding the swap throughout, and as if there had been no novaton; and
- the profits computed under the previous bullet point would have been taxed in the hands of the transferor, to the extent that they had accrued by the date of the novation (29th August 2003 on our actual facts), and in the hands of the transferee thereafter.

45. It is worth noting the following points in relation to this summary:

- Whilst the approved accruals basis of accounting obviously governs the way in which the profits of the deemed single company should be calculated at the second bullet point in paragraph 44 above, the feature that the profits prior to the novation are taxed in the hands of the transferor for the period up to the novation, and in the hands of the transferee thereafter, is not governed by which company is actually reporting the profits for accounting purposes. This is obvious since, it will be the transferor that would actually be reporting the vast majority of the profits if the swap was novated for full consideration of £91 million, and conversely the transferee that would be doing so if the swap was novated for nil consideration. None of this, however, is intended to affect the identification of the actual company that is taxed, under the notional rules, on the various elements of the notional "single company profit".
- The point just made does not, however, mean that the actual accounting treatment is irrelevant to the third issue dealt with below. The actual accounting treatment is central to that issue.
- It is also worth noting that the rollover rule is a slightly curious one in that, while it affects which company reports the profits for tax purposes, looking at the two companies together, it has virtually no bearing on the timing of the tax liabilities, save to the extent that the companies might have different accounting dates. Indeed, ignoring the identity of which group company pays tax on the profits, the inclusion of the rollover rule in the 2002 Act provisions makes little difference to the position that would have obtained under the 1994 Act.

The case where, without any novation to any group company, the original party to the derivatives (taxable within the 2002 regime) simply switched on 29th August 2003 from an accruals basis to a mark to market basis, with the then current accounting period ending on 31 March 2004

46. In paragraph 43 we assumed that both the transferor and the transferee were taxable on an accruals basis. It appears to us that had one single company switched from an accruals basis to a mark to market basis (say on 29th August), the result would have been as follows.

47. The relevant company would have brought the value of the contract into account at the date of the switch. The value brought into account in the company's statutory accounts would then have been included amongst the debits and credits (obviously the credits on the present facts) by paragraph 15(6) Schedule 26, this credit being added to the credits that would already have accrued in that period as at the date of the switch of basis. The resultant profit would then presumably be spread between the accounting period that ended on 31 March 2004 and over later periods for the remaining life of the contract.

48. Simultaneously mark to market calculations would have been made from the same valuation for the same current and future periods when the change of basis was made on 29th August, i.e. during the period that ended on 31 March 2004.

The novation of a swap from one group company to another, both covered by the 2002 rules, the first company computing its derivative profits on an accruals basis, the second on the mark to market basis

49. The reason why we dealt with the change from an accruals basis to the mark to market basis in the case of a single company in the previous paragraph is that it seems self-evident that when there is a transfer from one company to another (both covered by the 2002 regime) as we are now postulating, the result must be the same since we are required to calculate the credits and debits on the "same company" notion. On the "same company" notion, the same valuation must be made, with appropriate debits or credits (obviously credits on the present facts) being brought into account, essentially completing the final calculations on the accruals basis. On the facts of the present case (save for the fiction that we are now deeming the transferee to have been within the new regime), the credits to be brought into account on the accruals basis would include:

- the credits anyway accruing between 1 April 2003 and 29 August 2003; and
- the credit, resulting from the valuation of the swap contract in the accounts and the addition of that credit to the total calculations by virtue of paragraph 15(6) Schedule 26.

It appears to us that inevitably the credits indicated at the first bullet point above would be brought into account by the transferor that had held the swap during that period. There is no present significance in this Appeal to whether the credit mentioned at the second bullet point, or any element of that credit, would also have been brought into account in the hands of the transferor. Since that relevant credit would essentially anticipate profit referable to the tract of time after 29th August, we rather assume that the credit at the second bullet point would be brought into account, period by period, by the transferee, as being referable to the period when the swap was held by the transferee. Whether that is correct or not, the final component of the "same company profit", namely credits or debits measured on the mark to market basis from the valuation adopted in the second bullet point above, would plainly be brought into account in the hands of the transferee during the relevant periods.

The second issue

The Appellant's basic case in relation to the fact that the 2002 provisions applied to the Appellant on 29th August, but not to BIBF

50. The Appellant's hope and expectation, having regard to the fact that the novation was effected when the transferor was covered by the 2002 regime, along with the application of paragraph 28 Schedule 26 Finance Act 2002, whilst the transferee was not within that regime, was that the direction to ignore the novation under paragraph 28 would apply to the transferor, such that it would bring no profit into account. The transferee, however, would not inherit any tax liability in relation to the swap. It would have paid £91 million for the swap and it would have been taxed on the mark to market basis in the manner described for the transferee company in paragraph 42 above.

Paragraph 28 Schedule 26, Finance Act 2002

51. The main issue in this Appeal depends entirely on the proper interpretation of paragraph 28 of Schedule 26, and the general context of that provision, so that we must now quote the relevant paragraph. Ignoring irrelevant provisions, it read:

> *"**Transactions within groups***
>
> *28(1) This paragraph applies where, as a result of any transaction or series of transactions falling with sub-paragraph (2), one of the companies referred to ("the transferee company") directly or indirectly replaces the other ("the transferor company") as a party to a derivative contract.*
>
> *(2) The transaction or series of transactions referred to in sub-paragraph (1) are:-*
>
> > *(a) a related transaction between two companies that are:-*
> >
> > > *(i) members of the same group, and*
> > >
> > > *(ii) within the charge to corporation tax in respect of that transaction;*
> >
> > *(b) a series of transactions having the same effect as a related transaction between two companies each of which:-*
> >
> > > *(i) has been a member of the same group at any time in the course of that series of transactions, and*
> > >
> > > *(ii) is within the charge to corporation tax in respect of the related transaction;*
> >
> > *(c) …*
> >
> > *(d) …*
>
> *(3) the credits and debits to be brought into account for the purpose of this Schedule in the case of the two companies shall be determined as follows:*
>
> > *(a) the transaction, or series of transactions, by virtue of which the replacement takes place shall be disregarded except:-*

> (i) *for the purpose of determining the credits and debits to be brought into account in respect of exchange gains or losses and identifying the company which is to bring them into account, or*
>
> (ii) *for the purpose of identifying the company in whose case any credit or debit not relating to that transaction, or those transactions, is to be brought into account; and*
>
> *(b) the transferor company and the transferee company shall be deemed (except for those purposes) to be the same company.*
>
> *(4) …*
>
> *(5) …*
>
> *(6) …*
>
> *(7) This paragraph has effect subject to paragraphs 29 and 30.*

The competing contentions of the parties, and our conclusion in relation to each point

52. As we indicated in paragraph 9 above, we consider that it will be clearest if we deal with the contentions of the respective parties, and our own conclusions, on a step-by-step basis in relation to each point advanced by either of the parties.

Tax avoidance and purposive construction of legislation

53. Mr. Aaronson for the Appellant, commenced his submissions with the acceptance that the novation had been effected with a view to achieving a tax advantage, and that had Parliament introduced a General Anti-Avoidance Rule or GAAR prior to the scheme being effected, it would have been unlikely that the swap would have been novated at all. He argued, however, that since no GAAR had been introduced, no interpretation of paragraph 28 that we might reach could possibly be correct unless we upheld his contentions.

54. Mr. Prosser for the Respondents responded by saying that it was permissible to construe all tax legislation purposively and that, since the purpose of the "disregard" notion of paragraph 28 was plainly to achieve a symmetrical position as between transferor and transferee, it would be permissible for us to apply paragraph 28 in accordance with that obvious purpose. We would need of course to be able to advance some tenable interpretation of the provisions to accord with Parliament's presumed purpose, but he certainly contended that it was manifest that Parliament only intended a symmetrical result to be achieved by the operation of paragraph 28.

55. For our part, and disregarding the terms of paragraph 28 at this point, we certainly concede that if the draftsman of legislation has left some clear drafting error in commencement, transitional or "straddling period" provisions where one block of legislation has been substituted for another, correcting a drafting error by applying a purposive construction is often going to be difficult. This observation ignores the crucial issue of whether or not there was a clear error in this particular case or an interpretation that could accord with the obvious purpose.

The structure of the legislation

56. Mr. Aaronson placed some reliance on section 81 Finance Act 2002, and the point that that section indicated that the structure of the new code for taxing derivative contracts was to provide the substantive rules in Schedule 26 and the transitional rules in Schedule 28. Accordingly, since the present avoidance scheme sought to achieve an advantage, based on a failing of the transitional provisions, it was odd for the scheme to be undermined by a rule in paragraph 28, Schedule 26, since that did not essentially address transitional matters.

57. Mr. Prosser countered by drawing our attention to other instances where a point of transitional significance was included in Schedule 26.

58. Our conclusion is that the rule in paragraph 28 Schedule 26 is obviously a substantive on-going part of the 2002 code, but nevertheless if there is something in its wording that makes Parliament's purpose of confining the rule to the case where both transferor and transferee are within the new code, and a tenable interpretation of the provision can achieve that result, then that will indeed be the result. It would then perhaps have been odd for the rule in paragraph 28 to have had to be cross-referenced to some provision in Schedule 28 that would reverse the rule in the case of mismatched companies, if this could have been achieved simply by the wording of paragraph 28 itself.

"Companies within the charge to corporation tax"

59. Paragraph 28 provides the rule for disregarding a novation between group companies, and it only operates where both group companies are within the charge to corporation tax. It would admittedly involve a very strained construction, but one possible way of confining the operation of paragraph 28 to companies, both of which were within the new regime of Schedule 26, would have been to stretch the requirement that the companies should both be within the charge to corporation tax to mean "the same form of charge to corporation tax".

60. We accept, with Mr. Aaronson (and Mr. Prosser did not seek to dispute this) that such a construction is completely untenable. This was not so much because both companies were in any event within the charge to corporation tax "in respect of the transaction", but rather because in the earlier paragraph, namely paragraph 26 Schedule 26, the requirement that the transferee referred to in that paragraph should be within the charge to corporation tax in respect of the derivative contract dealt with by that paragraph was expressly concluded with the words "under this Schedule". When those were the words that we might seek to add to the references to "corporation tax" in paragraph 28, the fact that they appeared two paragraphs above paragraph 28 and not in paragraph 28 made it impossible to imply that further requirement when construing paragraph 28. Indeed, since those words would so obviously have defeated the aims of the present scheme, their very absence not only makes it impossible to imply them in construing paragraph 28 but their absence does point to a manifest drafting error, and thus favours the Appellant's case.

Parliament's purpose

61. We deal now with the question of whether Parliament's purpose in enacting paragraph 28 was indeed that the paragraph should always operate symmetrically. We agree with Mr. Prosser that this purpose is very evident. The opening words of

paragraph 28(3) refer to the *"credits and debits …. in the case of the two companies"* being determined, and paragraph 28(3) (a)(ii) refers to *"identifying the company in whose case any credit or debit* [relating to the derivative contract, rather than the novation] *is to brought into account"*. It did not in other words refer to the possibility that one company would bring debits or credits into account, while the other would bring nothing into account.

62. Mr. Aaronson advanced two arguments.

63. The first was that it would be inappropriate to stretch the language of paragraph 28 to enable it to achieve some perceived purpose when it operated perfectly correctly in the vast majority of cases. The percentage figure is not particularly relevant but we rather doubt whether to date something less than 1% of group company novations (Mr. Aaronson's estimate) happened to fall into the supposedly irrelevant category of novations between one company within and another not yet within the 2002 regime.

64. The second argument was that the scheme might have failed to achieve its purpose, in that once BIBF came within the 2002 regime (i.e. three days after the novation), it might then have inherited the remaining tax liabilities under the swap, thus escaping tax only in respect of accruals or value movements in the period between 28 and 31 August. Mr. Prosser asked Mr. Aaronson to explain the reasoning that might achieve this result, and Mr. Aaronson refused to do so. He indicated, however, that if the correct interpretation was as he suggested, then it might lead to the conclusion that there was no particular drafting error in paragraph 28, and that as HMRC were now plainly out of time to assess BIBF for any of the supposedly inherited profits under the swap, the outcome would simply be that the scheme ultimately succeeded merely because HMRC chose to assess the wrong company, i.e. the Appellant rather than BIBF, and were now out of time to assess BIBF.

65. We decide that all Mr. Aaronson's contentions were wrong. We will deal shortly with what we think is the correct interpretation of paragraph 28, but we find it decidedly improbable that Parliament would have been disinterested in whether a provision that would operate sensibly once all companies were within the 2002 regime might not do so in the straddling period. We also note that, whilst in this case only the profit arising in the two or three day period would have fallen out of charge under the contention mentioned in the previous paragraph, the period could have been much longer with different accounting dates, and may indeed have been much longer in other examples of the particular tax scheme that was perhaps implemented between group companies in other groups.

66. More relevantly, however, we cannot accept that it is even possible for one company (i.e. BIBF) to inherit tax liabilities under a transaction by the operation of a provision that was simply not in force, as regards that company, at the time of the transaction. It seems reasonable to suppose that the people who planned the particular scheme implemented by the Appellant and BIBF must have shared that view because they would be unlikely to have suggested a tax avoidance scheme on the basis that it did not work, but that there was a slim chance that HMRC would assess the wrong company, and then be out of time to assess the right one by the time they realised their error. We also observe that, whilst Mr. Aaronson raised the argument recorded in paragraph 64 above at a late point in the hearing, his own written Skeleton Argument had in fact dismissed the argument as untenable.

67. Quite apart from the fact that the scheme planners can obviously not have subscribed to the argument mentioned in paragraph 64, we decide that section 83(3) Finance Act 2002 clearly means that BIBF did not inherit any rolled-over liability under a provision that did not apply to it, and that there is nothing in Schedule 28 that qualifies or changes this conclusion.

68. We also agree with one final contention advanced by Mr. Prosser. Mr. Prosser drew our attention to the fact that paragraph 3 of Schedule 28 does address the transitional point of correcting the position should a company emerging into the new regime find that its tax liabilities in relation to a derivative contract under "the old regime" had been more or less than they would have been in those earlier periods, had the new regime in fact applied in the old periods. As Mr. Prosser pointed out, however, in making that comparison, we are expressly told in paragraph 3 Schedule 28 to disregard various paragraphs of Schedule 26 when calculating what the profits in the "old periods" would have been, had Schedule 26 in fact applied in those "old periods". And paragraph 28 was one of the rules to be ignored. This provision (to disregard paragraph 28 Schedule 26 when notionally applying the 2002 rules to the earlier calculation of profits during periods covered by the 1994 rules) does make perfect sense to us and it also appears to confirm the point that the paragraph 28 rollover rule is not meant to spring into operation once the 2002 rules apply to parties to a novation that actually took place when the 1994 rules were in operation. In written submissions made to us after the hearing, Mr. Aaronson advanced the point that the real drafting error was in paragraph 3 Schedule 28 and we must now address that contention.

69. Taking the example of a novation that occurred when both parties, transferor and transferee, were covered by the old rules, the result would initially have been as we indicated in paragraphs 41 and 42 above. Accordingly if the novation had been of an "in the money" swap and the transferor had received full consideration, most of the tax liability would have been left in the hands of the transferor, albeit that it would potentially be chargeable over the remaining life of the swap on the accruals basis.

70. If Mr. Prosser is right to suggest that the rollover rule of paragraph 28 (initially of course irrelevant) would **not** have sprung into operation if and when both parties became subject to the 2002 rules, the result would be that under the new rules the tax on the accruing profits would be left in the hands of the transferor. If then, in making the paragraph 3 comparison of the credits for the old periods, paragraph 28 Schedule 26 **was disregarded**, the likelihood is that there would have been no difference between the credit allocations and profit calculations in those old periods on the two different calculations (i.e. old rules and new rules), and therefore no adjustments to be made by paragraph 3 Schedule 28. The old rule calculations would, thus, have been left undisturbed in relation to the old periods, and on the present assumption that the rollover rule did not suddenly spring into operation once the new rules applied to the two parties, the same rule would effectively continue in force, and the absence of adjustments would make total sense.

71. If Mr. Aaronson is right to say that in the example given in paragraph 69 above, the rollover rule would suddenly have sprung into operation when the parties to the earlier novation became subject to the 2002 rules, the following result would arise. Taking the transferee, the transferee would suddenly have inherited the tax liabilities not from the date of the novation but from the point at which the 2002 rules came into operation. When then applying the paragraph 3 Schedule 28 rule, **as drafted,** to the periods **after the novation but before the application of the 2002 rules**, there would

have been no material differences in the allocation of credits as between the old rules and the new rules (when disregarding paragraph 28 Schedule 26), and accordingly no adjustment to be made by paragraph 3. There would thus be the curious result that even though there would be a total mismatch between the **unchanged** profit calculations for the old periods, and those for the post-2002 periods, no adjustment would be made. Were Mr. Aaronson's contention to be that paragraph 3 Schedule 28 thus contained a drafting error, and that in making the "old period comparison", it was **wrong to disregard** paragraph 28 Schedule 26, such that paragraph 3 Schedule 28 ought to have required adjustments to the old period calculations, so as to bring them into line with the feature that the rollover rule had sprung into operation when the 2002 rules first applied, we conclude that the end result would have been extraordinarily complex.

72. Mr. Prosser's analysis, given in paragraph 70, was relatively simple. It ended up with no mismatch between the two regimes because it left the 2002 rules operating as if there had been no rollover, and it was therefore coherent that no adjustment needed to be made by paragraph 3 Schedule 28. Mr. Aaronson's contentions would appear first to create a mismatch between the old and the new regimes (by the claim that the rollover rule, which had not operated initially, had sprung into operation when the 2002 rules came into force), and then it would seek to correct that by pointing to a drafting error in paragraph 3 Schedule 28, and requiring a paragraph 3 adjustment to be made because it was wrong, in applying the paragraph 3 Schedule 28 comparison of the two regimes for the old periods, to disapply the rollover rule when notionally applying the new rules.

73. We consider that Mr. Aaronson's competing analysis is wrong first because we see no basis for a rollover rule that was not in force at the time of the novation suddenly springing into operation, and secondly because it relies on a suggested drafting error in paragraph 3 Schedule 28, when the drafting of that paragraph is perfectly coherent on Mr. Prosser' analysis.

74. The fundamental point remains, however, that BIBF cannot have inherited liabilities under a transaction effected at a time when the required statutory provision that normally achieved that result, did not apply to it. We thus decide that no such thinking as Mr. Aaronson tentatively suggested in paragraph 64 above is even conceivable. It is plain to us, essentially for the reasons given in paragraph 61 above, and as a simple matter of common sense, that Parliament cannot have intended paragraph 28 to apply so as to let one company drop out of charge without the other inheriting the liability. And Mr. Aaronson's suggestion, advanced in paragraph 64 does not provide a tenable alternative analysis of how that objective can have been achieved.

The correct interpretation of paragraph 28

75. At a relatively early point in the hearing we indicated to the parties that while we had not reached a decision, it nevertheless seemed to be strongly arguable that even on a literal, let alone a very slightly strained, interpretation, paragraph 28 did not operate in the way in which it had to operate for the Appellant to succeed on the main point in this Appeal.

76. We entirely accept that so far as sub-paragraphs 28(1) and 28(2) are concerned, those sub-paragraphs do aptly refer to the situation of the Appellant and BIBF in relation to the novation. The Appellant's difficulty, however, is that it is sub-

paragraph 28(3) that governs what must be done when a transaction is effected by the parties covered by the opening two sub-paragraphs. And on the literal meaning of sub-paragraph 28(3) what must happen is that both the transferor and the transferee must be taxed in the manner provided. Sub-paragraph (3) does not apply disjunctively to the transferor and the transferee. Had it provided that where sub-paragraphs (1) and (2) applied, the transferor was to be treated in a particular way, and the transferee in another way, it is arguable that if one (say the transferor) was capable of being treated in the manner provided for it, whilst the other was not, then the transferor should still be treated as provided. But this is not how the paragraph was worded. It required the two companies to be treated in a clearly matching manner. If we address to the Appellant and BIBF the questions of "Is that how you have presented your respective returns?", and "Would it even have been possible to present your returns on the basis prescribed for the two companies together?", the answers would manifestly have been "No" and "No". It is quite clear to us, without remotely straining the language of paragraph 28 to achieve what was manifestly Parliament's purpose, that paragraph 28 only operates when the parties do what it directs should be done which is to bring into account *"for the two companies"* the various debits and credits prescribed by the slightly complex rules and the fictitious notions laid down by paragraph 28(3).

77. We then address the follow-on question of what should be done when a transaction has been effected by the parties identified by sub-paragraphs 28(1) and (2) but the direction prescribed by sub-paragraph 28(3) cannot be achieved. The resultant choice is between the following two possibilities. The first is to say that if the operative sub-paragraph cannot be applied and operated, then there is nothing to be done. The provision simply does not operate. The alternative is to strain the language of paragraph 28(3) and contend that even if it cannot operate in the manner that is clearly both required, and implicit (from the later notions in the sub-paragraph), it should still be treated as applicable to the one company even though that is not what is envisaged or directed. Since this is manifestly contrary to the obvious intent of Parliament, the conclusion is obvious to us. Our conclusion therefore is that, far from having to stretch the language of paragraph 28 against Mr. Aaronson's contentions, and in his view "to breaking point", such that on appeal our decision would be bound to be held to have been wrong, the reverse is the reality.

78. With Mr. Prosser, we accept that paragraph 28 was badly drafted in that none of this dispute would ever have arisen, had the reference to the two companies both being within the charge to corporation tax been extended to refer to that tax *"under this Schedule"*. However, even without those words, we conclude that, on a literal interpretation of paragraph 28(3), let alone a purposive construction, the direction was to calculate the tax of the two companies together in a manner that was simply not possible on the facts of the novation in this case. Furthermore it would be contrary to the manifest intention of Parliament for us to strain the language to enable it to be relied on by just one party to the transaction when it was clearly inapplicable to the other.

79. Our decision is that paragraph 28 Schedule 26 did not apply at all to the novation effected on 29th August 2003. It follows that in the period ending 31 March 2004 and later periods, the Appellant will be taxable on the £91 million, subject of course to any deduction for any premium initially paid for the swap (we assumed that none was paid, but we were not concerned to look at detailed calculations) and any other deductible costs. We deal in the following paragraphs with the position that we understood to be the agreed position between the parties as

to what proportion of the £91 million properly fell to be taxed in the period ending 31 March 2004.

The third issue - the calculation issue

80. As we indicated in the Introduction, when HMRC initially disputed the Appellant's claim that paragraph 28 Schedule 26 applied to the Appellant, HMRC's case was that once it was inappropriate to disregard the novation, it would follow that the Appellant would be taxed, on an accruals basis, on the whole of the £91 million received for the novation. On the basis of the then method of accounting, the resultant attribution of that profit to the Appellant's accounting period ended 31 March 2004 (the period the subject of this Appeal) was to attribute £23 million of the £91 million to that accounting period.

81. As we have also indicated, both parties accepted the view of the expert accountants representing each of them that the original basis of accounting failed to qualify as an acceptable accounting method, and that the accrued profit as at the date of the novation itself (29th August 2003), namely approximately £9.6 million should have been carried immediately to the profit and loss account. For a reason that was never explained to us, and that we had no need to understand, we were then told that if the balance sheet item of the remaining £81 million was attributed to the period ending 31st March 2004, with the remainder to be spread over later periods on the accruals basis, the amount to be attributed to the period ending 31st March 2004 was approximately £21 million. The result of this, therefore, whilst not affecting the more fundamental point that on some appropriate accruals basis the £91 million would be taxed in the hands of the Appellant in the relevant and later periods, the revised correct basis of accounting did increase the assessment for the period ending 31 March 2004 from approximately £23 million to approximately £30 million (i.e. £9.6 million and £21 million).

82. Since we were told that this was the correct calculation once a wrong basis of accounting had been replaced by the correct, and jointly agreed, basis of accounting, we confirm that the result of our decision in paragraph 79 above is that that increased figure is the amount by which the Appellant's original return for the period ending 31 March 2004 should be increased. We are referring in this Decision to the various figures of profit, and apportionments of profit, used during the hearing, which were usually approximate figures, so that it naturally follows that the assessment should actually be confirmed, on the principle summarised in this paragraph, but obviously with the inclusion of the correct detailed figures.

83. While it is obvious, we should perhaps confirm one final point. Considerable significance was attached in the "background" paragraphs, dealing with how the notional "same company profits" were to be allocated between the transferor and transferee when paragraph 28 Schedule 26 applied, and to the feature that that allocation was not influenced by which of the two companies was actually reporting the profits So far as this third point is concerned, where we are dealing with the situation in which paragraph 28 does not apply at all, the correct calculation of the element of the Appellant's profit of £91 million to its period that ended on 31 March 2004 is entirely governed by the correct accounting treatment.

The fourth issue - Whether the £9.6 million should still be taxable in the hands of the Appellant, if our decision on the second issue is wrong, and the Appellant is

right to say that paragraph 28 Schedule 26 did apply to the Appellant, notwithstanding that it did not apply to BIBF

84. HMRC's fallback contention was that if we decided that the Appellant's basic contention in relation to paragraph 28 Schedule 26 was correct (such that the Appellant should disregard the novation, whilst BIBF would take it into account), then nevertheless the £9.6 element of profit attributable to the period ending 29th August 2003 should still be taxable in the hands of the Appellant. The Appellant contended that on this assumption the £9.6 million should still be disregarded.

85. We might add that whilst this fourth issue is a relatively minor one, and an irrelevant one unless our decision on the second issue is overturned on appeal, the fourth issue is actually a very difficult one. The explanation for this, in our view, is that because we are seeking to indicate how provisions should operate in circumstances where we believe that they were not intended to operate, it is hardly surprising that the issue is difficult.

86. It is also worth mentioning that the rules that we will now deal with, contained in the Finance Act 2002, have all been amended, and we are obviously considering only how matters might have operated at the relevant time.

The contentions of the parties

87. On the actual facts of this Appeal, namely that the Appellant and BIBF were calculating their profits on an accruals and mark to market basis respectively, the former within the 2002 regime, and BIBF not yet within the regime, the parties respective contentions in relation to the £9.6 million question, were as follows.

88. The Appellant contended that the receipt of the £91 million on the novation included the £9.6 million referable to the profit that had already accrued, (i.e. the profit that should have been carried to the profit and loss account on acceptable accounting principles), and that it should be disregarded. That was both because it was inherently geared to the novation (being part of the receipt on the novation), and because absent the novation there would have been no calculation at 29th August, and no calculation of the £9.6 million. The plain words of sub-paragraph 28(3) required the £9.6 million receipt to be ignored.

89. The Respondents contended that the £9.6 million had got nothing to do with the novation, and was simply the accrued profit by the date of the novation. It was therefore an amount that emerged from calculating the ordinary credits and debits in respect of the swap itself, (or more accurately the various amounts of accrued income and accrued expenditure in respect of all 220 swaps) on the "same company" basis, and the reason why it was allocated to the transferor under paragraph 28(3)(a)(ii) was that that was the element of the "same company" profit attributable to the period of ownership of the swap by the transferor. In addition, since the correct basis of accounting required the Appellant to credit the accrued profit arising by 29th August to its profit and loss account, and that that element of profit had indeed accrued, regardless of whether the swap was novated on that day or not, this also demonstrated that the accrued profit at that time had nothing essentially to do with the novation. It was simply the appropriate accrual of profit on the swap itself as at that date. Accordingly it should not be disregarded.

Our decision

90. We dealt in paragraph 49 above with our understanding of how both parties would be taxed, were they both covered by the 2002 provisions, and were the transferor calculating its profits on the accruals basis at the time of the novation, and the transferee calculating its profits on the mark to market basis.

91. We consider that we must now deal with the following three issues:

1. First, were the assumptions that we made in paragraph 49 correct on the then assumption that both companies were in fact covered by the provisions of Schedule 26, and in particular paragraph 28 Schedule 26?
2. If they were right, and paragraph 28 can apply to the transferor when not applying to the transferee, is it right to suppose that the transferor on that basis should be taxed precisely as the transferor was dealt with in paragraph 49 above?
3. Is there any other basis that we should consider, in the obscure analysis of how to deal with two companies as one, when one was covered by the provision of paragraph 28 and the other was not?

92. We have no doubt that the summary that we gave in paragraph 49 above was correct. There is certainly no doubt that under paragraph 28 Schedule 26, the two companies treated as one are initially required to calculate the notional "same company profits" in respect of the swap, precisely as if there had been no novation. The only somewhat more difficult question is precisely how, and why, £9.6 million of the profit, i.e. the net income profit in respect of all of the swaps that had accrued by the date of the novation, should be allocated to the Appellant.

93. Our approach in paragraphs 44 and 45 (particularly the first bullet point in paragraph 45) and in paragraph 49 was to allocate the element of net income profit that had accrued by 29th August, namely £9.6 million, to the Appellant not so much because of the specific treatment of carrying £9.6 million to the profit and loss account of the Appellant, but rather because on a time basis, paragraph 28(3)(a) required us to split the notional "same company profit" between the two companies, and the natural attribution to make to the transferor was the amount of "notional same company profit" that had accrued by 29th August on the only then applicable basis, namely the accruals basis. We suggested, in the first bullet point in paragraph 45, that the allocation was based on that approach and not because on the facts of the present case, we were told that the Appellant should in any event have carried £9.6 million to the credit of its profit and loss account. That, we accept is a possible alternative explanation. We were unclear, however, whether £9.6 million would still have been carried to the Appellant's profit and loss account, **if the swap had been novated for nil consideration.** We assumed that in that event, the accounts to 31 March 2004 would have reflected no profit in respect of the swap since by the accounting date the profit would have been foregone and passed to BIBF. Accordingly the attribution of the £9.6 million would have had to be based on our explanation rather than by simply following the actual accounts. We note however that it is the Respondents' contention that the correct accounting treatment, in the case of the novation for nil consideration, would still have been to reflect the one time accrued profit (the £9.6 million) in the profit and loss account, even if the novation for nil consideration would require the recognition of some total accounting loss as a separate matter. If this accounting treatment is right, we accept that it may be the

actual accounting treatment that dictates the allocation of the £9.6 million of profit to the Appellant under paragraph 28(3)(a)(ii).

94. The salient point, however, is that whichever of these explanations is correct, all three result in the attribution of £9.6 million of credits and profit to the Appellant in the example in paragraph 49 above, and for present purposes it is immaterial which is the correct approach.

95. Addressing the second question now, namely whether the Appellant in our present case, on the hypothesis that paragraph 28(3) can apply to it when not applying to BIBF, should be dealt with any differently than the transferor in the example dealt with in paragraph 49 above, we can see no reason that it should be. The notion is extremely odd of course because it involves applying a provision of the legislation that in our view can only operate when applicable to both companies, to just one, but if that is feasible, and it should operate as regards the Appellant, then it seems to us that it should lead to exactly the same result for the Appellant as for the transferor in paragraph 49 above.

96. Addressing the third question, and noting on the facts of this case that the novation was effected for consideration of £91 million, and that the agreed accounting treatment of the Appellant should have required £9.6 million to be credited to the Appellant's profit and loss account, we consider that if there is any other basis for applying paragraph 28 to the Appellant, when not applying it to BIBF, that basis must still attribute £9.6 million of net credits to the Appellant. For that credit to the profit and loss account results simply from the fact that that element of net profits had arisen by that point in respect of the various swaps. It is simply an element of the profits on the swaps, and not a profit that results from the novation. Accordingly it should not be disregarded.

97. Whichever explanation thus accounts for why the £9.6 million amount of profit falls to be attributed to the transferor in the examples given in paragraphs 44 and 49 above, they inevitably all require the £9.6 million to be attributed to the transferor, and we decide that on the hypothesis that paragraph 28 could have applied to the Appellant, when not to BIBF, £9.6 million, the accrued profit by 29th August, should have been taxed in the hands of the Appellant.

Our decision in summary

98. We decide all three points, the closure notice issue, the substantive issue in relation to paragraph 28 Schedule 26, and HMRC's fallback issue in the event that we are wrong on that substantive issue, in favour of the Respondents.

Costs

99. Both parties applied for their costs in the event of their succeeding in this Appeal. We accordingly allow the Respondents their reasonable costs, calculated on the standard basis, any dispute in relation to quantum to be settled by the appropriate Costs Office.

Right of Appeal

100. 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.

HOWARD M. NOWLAN

TRIBUNAL JUDGE

RELEASE DATE: 8 April 2013

Amended: 21 June 2013