SLAUGHTER AND MAY

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The Upper Tribunal in *Ball UK Holdings* confirms that what generally accepted accounting practice (GAAP) is or whether something is in accordance with GAAP, are questions of fact, not law. HMRC loses again in *Smith & Nephew* as the Upper Tribunal confirms the FTT's decision that the accounts were GAAP compliant, the exchange losses were losses within the meaning of the legislation and did "fairly represent" losses. The US Treasury and IRS propose regulations which eliminate FATCA withholding on gross proceeds and defer withholding on "foreign passthru payments". The fourth annual report on the operation of the Code of Practice on Taxation for Banks published in December, reveals that the banks that have adopted the Code have been behaving themselves and that HMRC intends to include a commitment in the guidance to deal with Code approaches within 28 days.

Smith & Nephew: GAAP-compliant accounts and "fairly represents"

The first of two cases in this briefing to look at exchange losses arising as a result of a change in functional currency, *Smith & Nephew Overseas Limited and others v HMRC* [2018] UKUT 0393 (TCC) is an unusual example of a loss creation case being won by the taxpayer in the current climate. By way of contrast, *Ball UK Holdings*, discussed below, involved a scheme which had been disclosed under DOTAS and the Upper Tribunal (UT) decided that case against the taxpayer.

Following a reorganisation, the taxpayers changed their functional currency from sterling to US dollars. It was agreed that the taxpayers were obliged to change their functional currency, the point at issue was how to account for that change. Two accounting methods were in principle available and the method chosen was the one which triggered exchange losses of around £675m as a result of revaluations in the accounts. The losses were said to arise as a result of the fall in the value of sterling against the US dollar although the taxpayers had no underlying foreign exchange exposure and suffered no real economic loss. HMRC did not accept the losses arose for corporation tax purposes.

The FTT had concluded that:

- the taxpayers' accounts were in accordance with UK GAAP;
- the exchange differences gave rise to exchange losses within the meaning of the legislation; and
- those exchange losses did "fairly represent" losses within the meaning of the legislation (note that the "fairly represents" rule has been repealed).

HMRC appealed the FTT's decision on the ground that the FTT had erred in law in reaching all three conclusions. The UT concluded that the FTT had not erred in law in relation to the first two issues, and in relation to the "fairly represents" issue, the UT affirmed the conclusion of the FTT but differed from the FTT in its reasoning why the exchange losses did "fairly represent" losses within the meaning of the legislation.

The UT found that the FTT had erred in law in basing its conclusion on the reasoning that "fairly represents" has a limited attribution/timing proposition. The UT said *GDF Suez Teesside Ltd v HMRC* [2017] UKUT 68 (TCC) makes it clear that Finance Act 1996, s84(1) is wider than that,

operating as an override and imposing a separate and additional requirement for the recognition of profits and losses. Notwithstanding this error of law, the UT concluded that the FTT had reached the correct conclusion on the issue.

The change in functional currency was intended to trigger a foreign exchange loss for loan relationships purposes without there being any actual economic loss, but the transactions escaped being labelled as avoidance by the FTT. The UT endorsed this stating that "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." Although the UT did not accept the proposition that the "fairly represents" override can only ever apply in a tax avoidance case, the lack of a tax avoidance motive, taken with the absence of material asymmetry and the absence of an absurd result, led the UT to conclude the exchange losses in this case did fairly represent losses as required by the legislation.

Ball UK Holdings: GAAP-compliant accounts

Ball UK Holdings v HMRC [2018] UKUT 407 (TCC) involved a scheme to create a foreign exchange loss without there being any economic loss by changing functional currency. HMRC had successfully argued before the FTT that the accounts which treated the functional currency as dollars were not in accordance with UK GAAP because they should have treated the functional currency as sterling. This was so even though three out of the four "Big 4" accountants had, in one way or another, supported the taxpayer's view that the accounts were in accordance with GAAP. The question in dispute before the UT was whether Ball UK's accounts were prepared in accordance with UK GAAP for the purposes of what was, at the relevant time, FA 1996 s85A, now CTA 2009 s307. The UT dismissed the taxpayer's appeal.

In the *Ball UK* case, unlike in *Smith and Nephew*, it was clear to the FTT that the taxpayer had implemented a scheme to avoid tax promoted by PwC which had been disclosed under DOTAS, although this was not referred to by the UT.

The UT concluded that the question of what is generally accepted accounting practice, as well as the question of whether a particular set of accounts is prepared in accordance with it, is a question of fact to be determined with the assistance of expert evidence. The role of the UT in this case was therefore limited to determining whether the conclusions reached by the FTT were ones that could properly be reached on the evidence.

The UT held that the FTT was entitled to prefer the evidence of Mr Chopping from Moore Stephens that the focus is on the economic environment in which the entity operates (the UK), not the location of decision making (the US, where its parent company was resident). The UT concluded that the FTT correctly allocated weight to the other factors in FRS 23 on Ball UK's facts and that the "Big 4" manuals and other evidence as to the interpretation of FRS 23 adopted by accounting professionals in practice did not preclude the FTT from deciding on the basis of expert evidence that Ball UK's accounts did not in fact comply with GAAP because the functional currency should have been sterling.

The Upper Tribunal's confirmation that what is GAAP, or whether something is GAAP compliant, is a question of fact, is very welcome. In many cases, of course, it has been HMRC, not the taxpayer, arguing the opposite. It is not uncommon for the argument that the taxpayer's accounts are not GAAP-compliant to be lobbed in alongside a number of other arguments, then if HMRC lose the GAAP argument but win on something else they have continued to try to run the accounts argument before the higher courts on the basis of mistake of law. That's exactly what happened in both the UT and Court of Appeal in *GDF*. In that case, whilst the taxpayer continued to argue it is a question of fact, not law, the point has never been shut down as cleanly as by the UT in *Ball UK Holdings*.

Taxpayer's counsel ran this case in the main as a question of interpreting accounting standards. It might be thought a bit strange that in a case which is all about whether a particular accounting treatment is UK GAAP compliant, there is no consideration at all of what GAAP actually means. GAAP is a bit like an onion – there are many layers of standards, principles etc. but GAAP is really how these layers are generally accepted and applied by accountants in practice (hence the name). Given that three of the Big 4 seemed to be onside here – PWC audited the accounts as being GAAP compliant, KPMG gave the taxpayer's expert evidence and there was a report from Deloitte supporting the accounting treatment (and no evidence either way from EY) – it is surprising that the taxpayer did not try harder to run an argument that it is not reasonable for the FTT to say the treatment was not generally accepted accounting practice if the evidence before it is that three quarters of the Big 4 think it is and only Moore Stephens thinks it is not. But when taxpayer's counsel tried to use the Big 4 Manuals as evidence of their application in practice, first the FTT, and then the UT, said they were being used, in reality, to support Ball UK's *interpretation* of GAAP, not as *evidence of application*. This is yet a further contrast with *Smith & Nephew* where FTT allowed the taxpayer to point to the Big 4 Manuals in support of the accounting method adopted. The FTT in *Smith & Nephew* recognised that while the guidance in the Big 4 Manuals was "not authoritative" it did "describe what many accountants in those larger firms see as practice on a day-to-day basis".

US regulations to reduce compliance burden under FATCA

In December, the IRS and US Treasury published proposed regulations in response to comments received suggesting modifications to the FATCA regulations (under chapter 4 of the Internal Revenue Code) and to regulations under chapter 3 of the Internal Revenue Code (the "normal" US withholding rules) to reduce the burden of compliance. Note that entities resident in countries with a Model 1 intergovernmental agreement (IGA) with the US, such as the UK, do not have to apply gross proceeds withholding or foreign passthru withholding in any event under the terms of the IGA. An awareness of these changes is, however, essential for the purpose of updating documents which contain FATCA risk allocation provisions.

Elimination of gross proceeds withholding

Withholdable payments made to certain foreign financial institutions (FFIs) and to certain non-financial foreign entities are subject to FATCA withholding. The term "withholdable payment" is broadly defined and includes "any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the US". Gross proceeds withholding was due to commence on 1 January 2019 but the Treasury department and the IRS have listened to comments and concluded that withholding on gross proceeds is no longer necessary in light of current compliance with FATCA. The proposed regulations eliminate withholding on gross proceeds by removing gross proceeds from the withholdable payment definition and making other consequential changes.

Deferral of withholding on foreign passthru payments

An FFI which has entered into an agreement with the IRS is required to withhold on any passthru payments made to recalcitrant account holders and to non-compliant FFIs. The 2017 FATCA regulations provided that such withholding will not begin until the later of 1 January 2019 or the date of publication in the Federal Register of final regulations defining the term "foreign passthru payment". The proposed regulations further delay the commencement for withholding on foreign passthru payments so no withholding is required before the date that is two years after the date of publication in the Federal Register of final

regulations defining the term “foreign passthru payment”.

It is a shame the IRS/Treasury did not take the same approach as for gross proceeds withholding and eliminate passthru payment withholding completely but they are still concerned that they need it to prevent non-participating FFIs from avoiding FATCA by investing in the US through a participating FFI “blocker”. Accordingly, the Treasury and IRS continue to consider the feasibility of a system for implementing withholding on foreign passthru payments and request additional comments from stakeholders on alternative approaches that would serve the same compliance objectives and that could be more efficiently implemented.

HMRC’s annual report on the Code of Practice on Taxation for Banks

The Code of Practice on Taxation for Banks (the Code) requires banks to comply with the spirit, as well as the letter, of tax law, discerning and following the intentions of Parliament. The fourth annual report on the operation of the Code was published in December, revealing that the banks that have adopted the Code have been behaving themselves: not making any DOTAS disclosures and having Code compliant governance and behaviours.

A bank may approach HMRC where the bank is unsure whether or not the tax result of a proposed transaction is contrary to the intentions of Parliament. In the period 1 April 2017 to 31 March 2018, banks made nine pre-transaction Code approaches compared with nineteen in the 2016/2017 reporting period. Six of these were agreed to be Code compliant, two of them were outside the scope of the Code as the tax planning did not result in a change to the UK tax position and in the final case, the bank decided not to proceed with the transaction before a decision had been reached.

HMRC intends to include a commitment in the Code guidance to respond to Code approaches within 28 days but will endeavour to agree the Code position more quickly where there is commercial imperative. (The turnaround time for Code approaches has increased from 10 days in 2015/16 and 20 days in 2016/17.) If HMRC asks for more information, the time taken for the bank to respond is excluded from HMRC’s response time. During the 2017/2018 reporting period, four of the six Code approaches considered were dealt with in less than 28 days.

As a result of consultation on the business risk review process in 2017/18, an enhanced business risk review process for banks will be piloted during 2018/19 with a view to full implementation during 2019/20 if the pilot proves successful.

What to look out for:

- On 21 January, the Court of Appeal begins hearing the cases of *Standard Chartered, MG Rover* and others about which member of a VAT group has the right to bring a repayment claim for overpaid VAT.
- The closing date for comments on the amendments to the corporate loss relief for capital losses is 25 January. Specific proposals are made in respect of companies with Basic Life Assurance & General Annuity Business (BLAGAB). As the government intends that the restriction will only affect companies, chapter 5 of the consultation document explains that the policyholders’ share of BLAGAB gains and losses is excluded from the scope of the measure.

- The closing date for comments on the stamp taxes on shares consideration rules is 30 January. Rather than fundamentally reforming the stamp taxes on shares rules as suggested by the OTS, the consultation document on changes to the consideration rules tinkers with some aspects of the rules, making them more, not less, complex to apply.

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Mike lane
T +44 (0)20 7090 5358
E mike.lane@slaughterandmay.com

Zoe Andrews
T +44 (0)20 7090 5017
E zoe.andrews@slaughterandmay.com

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For further information, please speak to your usual Slaughter and May contact. 557090887