[2018] UKFTT 20 (TC)

TC06295

Appeal number: TC/2016/04549
TC/2016/04585

Corporation tax– oil companies –supplementary charge on ring fence profits –change of rate – just and reasonable apportionment between periods – appeals allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

Maersk Oil North Sea UK Limited (1) **Appellants**
Maersk Oil UK Limited (2)

- and -

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

TRIBUNAL: JUDGE Rachel Short

Sitting in public at Taylor House, 88 Rosebery Avenue London on 13 November 2017

Mr Laurent Sykes QC of Gray's Inn Tax Chambers instructed by Vinson and Elkins RLLP for the Appellants

Mr Michael Jones, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. This is an appeal by (i) Maersk Oil North Sea UK Limited ("MONS") against a notice of amendment of MONS' self-assessment issued by HMRC on 21 April 2016 assessing the company to an additional £2,395,540.00 of corporation tax for its accounting period ending 31 December 2011 and (ii) by Maersk Oil UK Limited ("MOUK") against a closure notice issued by HMRC on 16 November 2015 assessing the company to an additional £4,474,785.52 of tax for its accounting period ending 31 December 2011.

2. MONS submitted its corporation tax computations for the 2011 accounting period on 12 December 2012. HMRC notified MONS on 10 December 2013 of their intention to enquire into MONS' corporation tax return. HMRC concluded that enquiry and issued a notice of amendment to MONS' tax return on 21 April 2016. This amended return was upheld by an HMRC review dated 28 July 2016. MONS appealed to this Tribunal by an appeal dated 23 August 2016.

3. MOUK submitted its corporation tax computation for the 2011 accounting period on 12 December 2012. HMRC gave notice of their intention to raise an enquiry into that return on 10 December 2013. HMRC concluded that enquiry and issued a closure notice on 16 November 2015. HMRC's position was upheld on review dated 28 July 2016. MOUK appealed to this Tribunal by an appeal dated 23 August 2016.

4. These two appeals were consolidated by a Tribunal direction of 11 November 2016.

Background facts

5. Both MONS and MOUK carry on oil related trades. They are subject to UK corporation tax on the profit of those trading activities as if they amount to a separate ring fenced trade in the UK. The profits generated by these activities are referred to as ring fence profits.

6. UK tax legislation applies a supplementary tax charge, over and above normal corporation tax, on these ring fence profits. The supplementary charge was set at a rate of 20% from 1 January 2006 until 23 March 2011. On 23 March 2011 the supplementary charge was increased overnight to 32%: a 12% increase.

7. The legislation which introduced this rate change, the Finance Act 2011, stated that companies with open accounting periods at the date of the rate change, 23 March 2011, should treat the periods before and after the rate change as two separate accounting periods and allocate their profits between those periods on a time apportioned basis. In response to industry lobbying, an additional provision was included in the legislation which allowed companies to choose to use a method other than time apportionment if the company considered that time apportionment of profits would give rise to an unreasonable or unjust result.

8. Both MONS' and MOUK's corporation tax returns for the accounting period ended 31 December 2011 included an election made under s 7(5) of the Finance Act 2011 that for the purposes of calculating the supplementary charge for the period after the rate change on 23 March 2011, the companies' profits should be apportioned by reference to an actual basis rather than the statutory time apportioned method.

9. HMRC accepts that both MONS and MOUK can make an election under s 7(5) Finance Act 2011 because a time apportioned method would be unjust or unreasonable, but does not accept that the alternative "actual" method of apportionment used by MONS and MOUK is a just and reasonable method of apportionment for the purposes of s 7(5) FA 2011. HMRC has suggested its own apportionment of profits for both MONS and MOUK which results in a greater percentage of the profits of both of the companies being allocated to the higher tax, post-24 March 2011 period.

The business of MONS during 2011

10. During the relevant period MONS was the operator of six oil fields in the North Sea: Gryphon, South Gryphon, Tullich, Boa, Lochranza and Dumbarton (with MOUK). It was also had joint interests in three other fields; Maclure, Harding and Wytch Farm, of which it was not the operator.

11. The Gryphon, South Gryphon and Tullich fields all tied back to the Gryphon Alpha Floating Production and Storage Offloading vessel ("Gryphon FPSO"),

12. During a severe storm in the North Sea on 4 February 2011 the Gryphon FPSO had technical problems. The FPSO lost power, four of its ten anchor chains failed and it moved off station by 100 metres, dragging sub-sea equipment with it, causing all of its risers to be disconnected and leading to the destruction of most of its subsea equipment. Extensive damage was also suffered to the FPSO itself. The result of this damage, referred to as the Gryphon incident, was that the Gryphon, South Gryphon, Maclure and Tullich fields all suffered a "shut in" pending repair to the equipment. The Gryphon field shut in last for two years.

13. MONS incurred capital expenditure of $245,885,402 after 24 March 2011 in relation to the Gryphon incident. MONS also received two insurance payments as a result of the Gryphon incident (i) a payment of $266,298,078 "Loss of Production Insurance" and (ii) a payment of $55,039,192 "Property Damage Insurance". This property insurance payment resulted in a balancing charge arising for capital allowances purposes.

The business of MOUK during 2011

14. During the relevant period MOUK had a license share in four fields in the North Sea; Janice, Affleck and Dumbarton (with MONS). It was also involved in two other fields of which it was not the operator (Telford and Scott).

15. Of those fields, there was a two month shut in at Dumbarton from July until August 2011 and long term issues with the Janice Floating Production Unit ("FPU")

to which the Janice and Affleck fields were tied. The Janice FPU's scheduled "shut in" was delayed and lasted for 12 days rather than the five days planned. A second planned shut in expected to last 26 days actually lasted 180 days (of which 69 fell within the 2011 period, from 24 October 2011 until the end of 2011).

The law

16. This appeal is concerned with one specific provision of the rules which applied the increased level of the supplemental charge from 23 March 2011, section 7(3) – (6) of the Finance Act 2011 ("FA 2011"):

> *"(3) Subsections (4) to (10) apply where a company has an accounting period beginning before 24 March 2011 and ending on or after that date ("the straddling period")*
>
> *(4) For the purpose of calculating the amount of the supplementary charge on the company for the straddling period –*
>
> > *(a) so much of that period as falls before March 24 2011, and so much of that period as falls on or after that date, are treated as separate accounting periods, and*
> >
> > *(b) the company's adjusted ring fence profits for the straddling periods are apportioned to the two separate accounting periods in proportion to the number of days in those periods.*
>
> *(5) But if the basis of apportionment in subsection 4(b) would work unjustly or unreasonably in the company's case, the company may elect for its profits to be apportioned on another basis that is just and reasonable and specified in the election.*
>
> *(6) The amount of the supplementary charge on the company for the straddling period is the sum of the amounts of the supplementary charge that would, in accordance with subsections (4) and (5), be chargeable on the company for those separate accounting periods."*

17. HMRC have accepted that both MOUK and MONS can make an election under s 7(5). This was confirmed for MONS by a letter dated 27 November 2015. For MOUK, HMRC accepted this with some caveats by letter of 28 January 2016 saying that "*we have not altered our technical view as regards the interpretation of s 7 FA 2011, but in order to progress the issue we are willing on a without prejudice basis to accept a s 7(5) election in this case*".

18. The Tribunal was also referred to the following case authorities:

(1) *Anthony Bayliss v HMRC* [2016] UKFTT 0500.

(2) *Marshall Hus v Bolton* 55 TC 539.

Evidence

19. Accounting evidence seen:

(1) Directors' Reports and Financial Statements of MONS and MOUK dated 31 December 2011. MONS' profit and loss account for the period shows a loss of $10,729. MOUK's profit and loss account for the period shows a loss of $71,175.

(2) MONS corporation tax computation for the period ended 31 December 2011.

(3) MOUK corporation tax computation for the period ended 31 December 2011.

(4) Forecasts and actual results for MONS and MOUK for the accounting period ended 31 December 2011 dated 9 July 2015.

20. Various correspondence between the parties including:

(1) HMRC review conclusion letters for MOUK and MONS both dated 28 July 2016.

(2) Notes of a meeting between HMRC and Maersk of 16 December 2015 and Maersk's presentation material used for that meeting.

21. Various correspondence between HMRC, members of the UK government and the UK Oil Industry Taxation Committee (UKOITC) from February 2005 to October 2011 concerning changes to the supplementary charge.

Witness evidence

Mrs Ritchie

22. I saw two witness statements from Mrs Linda Ann Ritchie dated 13 March 2017 and 8 August 2017. Mrs Ritchie is the tax manager of MONS, responsible for managing corporate tax compliance, monthly reporting, forecasting and planning for MONS and MOUK. Mrs Ritchie gave oral evidence to the Tribunal and was cross-examined by Mr Jones.

23. Mrs Ritchie explained that the change in the supplementary charge introduced by the Budget on 23 March 2011 came as a great shock to her and her colleagues and others in the oil industry including representatives at the UKOITC of which she was a member.

24. Mrs Ritchie set out the reasons why she had decided that MONS and MOUK should make an election under s 7(5) FA 2011 for an alternative to time apportionment of profits for the period when the change of rate was introduced.

MONS

25. Mrs Ritchie referred to the unexpected catastrophic events which occurred during 2011 and had a negative effect on MONS' profits for the 2011 period, principally the 4 February 2011 storm incident leading to a total stoppage of production from the Gryphon area for two years and extensive repair work to the Gryphon FPSO.

26. Mrs Ritchie said that when the Gryphon FPSO was put into dry dock the opportunity was taken to accelerate some upgrades to extend its economic life which would otherwise have been done at a later date. She could not specify what elements of the expenditure incurred related to these upgrades rather than to the repair work from the Gryphon incident, but did say that of the significant capital expenditure incurred by MONS towards the end of 2011 a main component was the repair of the equipment damaged in the Gryphon incident.

27. Mrs Ritchie explained that a claim was made under an insurance contract for the loss of production in the Gryphon Area. The first insurance claim could not be made until April 2011. A property damage insurance claim was also made but this was not agreed until after the end of 2011. A contribution towards initial property damage costs of $30 million was made in June 2011.

28. During 2011 Dumbarton was also "shut in" for maintenance work. As is usual in the North Sea this was done during the summer months because of more favourable weather conditions. Mrs Ritchie accepted that it was usual for profits of companies which were involved in North Sea oil extraction to be lower in the summer because this was when maintenance work was usually carried out.

29. Mrs Ritchie said that for each month of 2011 MONS' turn-over had exceeded its operating expenses.

MOUK

30. Mrs Ritchie explained why the Janice FPU operated by MOUK had suffered an unexpected prolonged shut down from 24 October 2011 until 21 April 2012; this shut down was extended due to technical issues with the installation of new control and safety systems, new mercury removal units and a new well in the Janice Field. While it was not usual for shut downs to run over by a few days, an over run of this length was unusual.

31. This led to production volumes in the Janice FPU being reduced in 2011 by 35.5%. MOUK did not receive any insurance payments to compensate for this loss of production.

32. Like MONS, MOUK's profits followed the seasonal nature of the industry, being shut down for repairs in the summer, meaning that profits were higher in the winter months, but this extended shut down resulted in MOUK's production volumes being below forecast.

33. Mrs Ritchie said that these events meant that the profits of both MONS and MOUK were concentrated in the early months of the year for 2011. Applying a time apportioned basis for profits would have worked unfavourably for both companies.

Tax computations

34. Mrs Ritchie told the Tribunal that she prepared monthly financial reports including tax computations and these showed that the group's taxable profits declined as 2011 progressed, meaning that applying tax on a time apportioned basis would lead to retrospective taxation. This was what led her to make the s 7(5) election for both companies; she recognised that if capital allowances were taken account of neither MONS nor MOUK had made profits during the second half of 2011.

35. Her view was that the best way to minimise distortion for the companies was to consider the pre-and post-March 24 periods independently, as if they were two separate accounting periods and allocate income, expenditure and allowances on what she referred to as an "actual" basis, allocating them to the periods in which they arose. She said

> "*An actual basis, (as if the company had actually closed an accounting period) seemed to me the most natural way to apportion profits and it did not cross my mind that HMRC may consider an actual basis as unjust or unreasonable. I did not consider any other basis, such as apportioning profits before capital allowances on an actual basis but then spreading capital allowances throughout 2011 on a time apportionment basis*."

36. Mrs Ritchie explained that both MOUK and MONS prepared their accounts for internal reporting purposes on the basis of IFRS but their financial statements were prepared under UK GAAP. She told the Tribunal that no significant differences arose as between UK GAAP and IFRS which affected the underlying transactions during 2011.

37. Mrs Ritchie told the Tribunal that she used the management accounts for MOUK and MONS as the basis for allocating items of income and expenditure to the pre-and post-March 24 periods, with pro-rating done (including of capital allowances) for the month of March only on a day count basis. Those management accounts were produced on an accruals basis.

38. This meant that the full amount of the loss of production insurance proceeds received by MONS in relation to the Gryphon incident were allocated to the post- 24 March 2011 period and the initial payment from the property damage insurance was also included in that period, both of which worked to MONS' disadvantage, since it increased that company's profits for the higher tax period. As agreed with HMRC, the insurance proceeds received relating to the destruction of the subsea equipment were treated as a claw-back of capital allowances in the pre-24 March 2011 period.

39. Capital allowances were allocated by reference to the dates when expenditure was incurred (in accordance with s 5 Capital Allowances Act 2001) for both MONS and MOUK on the basis of the figures in the management accounts. This gave rise to

$405,066,519 of capital allowances arising to MONS in the post-24 March 2011 period and $140,803,501 of capital allowances arising to MOUK for the post-24 March 2011 period. Mrs Ritchie explained that she could not identify exactly what capital expenditure had given rise to the capital allowances available to MOUK or MONS or whether that expenditure was related to the unexpected events of 2011 or to scheduled repairs.

40. Mrs Ritchie accepted that some of the figures included in her 2011 tax computations could have been further refined (such as the figures relating to pensions and materials), but provided figures to demonstrate that even with these refinements there would still have been a loss in the post-March 24 2011 period.

41. Mrs Ritchie set out the details of her correspondence and meetings with HMRC in an attempt to agree the tax in dispute for MONS and MOUK for 2011 and expressed her view that HMRC's central argument was that it was not just and reasonable to apportion capital expenditure to the post-March 24 period, even though the expenditure was incurred in that period.

42. In response to HMRC's own witness evidence, Mrs Ritchie re-iterated her position that "*faced with a blank sheet of paper, it seemed obvious to me that if I were to apply a basis of apportionment other than simple time apportionment, then an apportionment based on the Appellants' actual profits per month would be the most natural alternative and equate to one that is both just and reasonable to all parties*" and that it had not been her intention to avoid the supplementary charge increase entirely.

43. Mrs Ritchie also commented on some detailed aspects of HMRC's proposed method; explaining that she did not accept that the property damage insurance proceeds should be netted off against the capital expenditure incurred in the post-March 24 period. HMRC had agreed (in a clearance letter of 20 December 2011) that the property insurance proceeds should be treated as disposal proceeds for capital allowances purposes. The event giving rise to that disposal was the Gryphon incident on 4 February 2011 and therefore those proceeds had been allocated to that period, whereas the capital expenditure had been incurred after 24 March 2011.

44. Mrs Ritchie said that her allocations of capital expenditure had been done by reference to the tax legislation which treated expenditure (for first year allowances) as arising on the date when it was incurred. This was a reasonable and not an arbitrary basis of apportionment.

45. Mrs Ritchie also took exception to the suggestion by HMRC that 65% of MONS' turnover, and 62% of MOUK's arose in the post March 24 period, suggesting that because of changes in oil prices, production values, rather than turn-over, was a more accurate comparator; on this basis MONS suffered an 86.7% reduction in production as against forecast for the entire year and MOUK a 35.5% drop. She said that any reliance on volumes, turn-over and operating expenses could not fairly reflect MONS' profits because they failed to take account of the very significant capital expenditure incurred by MONS during the post March 23 period.

46. Overall Mrs Ritchie insisted that she attempted to consistently apply an "actual" basis of apportionment, regardless of whether or not that worked in favour of MONS or MOUK, for example the emergency insurance receipts of $30 million and the loss of production insurance receipts were recognised in the post-24 March 2011 period because that was when they were received.

47. Mrs Ritchie could not confirm whether MONS and MOUK were profitable in 2012, but did confirm that they were both loss making for 2010.

Mr Sherriff

48. I saw a witness statement from Mr James Richard Sherriff dated 7 April 2017. Mr Sherriff gave oral evidence to the Tribunal and was cross-examined by Mr Sykes. Mr Sherriff is an enquiry co-ordinator with HMRC and his responsibilities include the project management of tax disputes between oil companies such as the Appellants and HMRC.

49. Mr Sherriff explained in his witness statement that HMRC's view of elections made under s 7(5) FA 2011 is first, that companies making such an election have to show that time apportionment works unjustly or unreasonably because "*profits are not earned rateably but are driven by an extreme or significant event*" and second, that the alternative basis proposed by the company making the election must be "*just and reasonable and consistent with the nature of the company's trade and the circumstances under which it considers the election appropriate"*.

50. Mr Sherriff said that in deciding whether an allocation was just and reasonable he had considered relevant indicators. In his view a cessation of trade or a cataclysmic event would support a move away from time apportionment. If a company's trade was on-going, as MONS' and MOUKS' was, then other indicators needed to be considered to judge whether an allocation was just and reasonable, such as turn-over, production volumes and operating expenses.

51. Mr Sherriff also explained that HMRC had proposed their alternative profit apportionments as part of their negotiations with the Appellants to explore whether there were other methods of allocation which were preferable to the basis applied by the Appellants.

52. Mr Sherriff also said that in his view the Appellants were not permitted under s 7(5) FA 2011 to elect for a basis of apportionment which was less just and reasonable that a simple time apportionment.

MONS

53. Mr Sherriff told the Tribunal that HMRC did not consider that the Appellant's apportionment method was just and reasonable *"taking account of the circumstances of MONS throughout the period*" in particular that it earned 65% of its sales income during the post- March 24 period from fields unaffected by the Gryphon incident. The method adopted by MONS would be appropriate for a company which had ceased

trading altogether in the second period, but that was not what had happened to MONS.

54. Mr Sherriff said "*The alternative apportionment used by MONS that effectively avoided the rate change did not, in HMRC's view, produce a just and reasonable result by reference to production volumes, turnover and operating expenses as indicators of economic activity over the profitable 12 months of the accounting period*". He pointed to the fact that 65% of MONS' total sales income arose in the second period, so the majority of its profits should also have arisen in the second period and 62% of MONS' turnover arose in the second period. Operating expenses were also higher in the second than the first period ($59.5 million as compared to $99.9 million).

55. Mr Sherrif explained the approach used by HMRC which he described as "*reflecting the circumstances of MONS in an alternative method to time apportionment*", avoiding the allocation of 102% of MONS' adjusted profits to the pre-March 24 period. Mr Sherriff described MONS' approach as a re-computation rather than a re-allocation of profits and said that HMRC were not prepared to accept an allocation of all capital expenditure to the post-March 24 period because some of this related to the Gryphon incident in the earlier period.

56. Mr Sherriff also objected to MONS allocating expenses to the post-March 24 period which were not linked to the Gryphon incident. HMRC's method attempted to use time apportionment but also aimed to better reflect the impact of the Gryphon incident. In Mr Sheriff's view any departure from time apportionment must be by reference to specific events. Therefore HMRC's reallocation (i) moved some of the Loss of Production Insurance from the second to the first period (rateably by reference to the number of days in both periods after the Gryphon incident (ii) moved the capital allowances (net of the balancing charge) across both periods on a time apportioned basis starting from the date of the Gryphon incident.

57. Mr Sherriff explained his understanding that as a result of the Gryphon incident MONS incurred capital expenditure after 23 March 2011 of $245,885,402 but also received Loss of Production Insurance (of $266,298,078) and Property Damage Insurance (of $55,039,192). The effect of the receipt of the Property Damage Insurance was that a balancing charge arose for capital allowance purposes, leaving $190,846,210 of capital allowances available for the whole of the 2011 accounting period.

58. HMRC's method was a more just and reasonable apportionment because it focussed on the income and capital allowances which could be separately identified as relating to the Gryphon incident, but went no further than was necessary to address these specific issues. HMRC objected to MONS' approach because it was not an approach which could be supported by s 7(5) and because it produced an outcome which was not just and reasonable taking account of the fact that MONS made profits for the post-March 24 period.

59. Mr Sherriff accepted in response to questions from Mr Sykes that the figures which he had apportioned across the two periods included the Loss of Production Insurance payments but that this had also been apportioned as a separate item, meaning that it had been double counted.

MOUK

60. Mr Sherriff's concerns with the basis on which MOUK had calculated its taxable profits for the purpose of its election under s 7(5) were broadly similar to those he expressed for MONS: (i) MOUK, like MONS, had re-calculated rather than re-allocated the profits which arose for the pre- and post-24 March periods and (ii) MOUK's method of apportionment was not more just and reasonable than time apportionment or HMRC's method.

61. The result of MOUK's method of apportionment was to apportion 147% of its ring-fenced profits to the pre-March 24 period. MOUK actually achieved 68% of its turnover during the post-24 March 2011 period. Mr Sherriff described MOUK's apportionment method as highly artificial and not reflective of the fact that MOUK continued to trade during the second period.

62. Mr Sherriff pointed out that looking at forecasts and actual production achieved by MOUK in 2011, the difference was small; a 56% production contribution compared with an actual contribution of 47%. 62% of MOUK's turnover arose in the second period and the majority of its operating costs were also incurred in the second period ($27.1m compared to $106.4m). The company continued its core activities and made profits throughout the second period

63. MOUK's method of allocation allocated capital allowances which related to the whole of the 2011 accounting period to the pre-24 March 2011 period. The capital allowances in question arise from the normal course of MOUK's operations and there was no justification for moving away from a time apportionment basis for these allowances. MOUK's approach was less just and reasonable than a time apportionment method.

64. HMRC's method had taken turnover and expenditure figures from MOUK's management accounts but excluded significant amounts of capital allowances which would otherwise distort the apportionment. HMRC had taken the percentage split of profits between the first (53%) and second (47%) periods and applied those percentages to the total figure for the adjusted ring fenced profits. This brought tax profits more closely into line with the production profile of the company. HMRC's method placed 53% of adjusted ring-fenced profits in the pre-March 24 2011 period.

The Appellants' arguments

65. The Appellants completed their corporation tax returns, including their s 7(5) elections applying what Mrs Ritchie described as an "actual basis" and splitting the

2011 accounting period into two periods, one from 1 January 2011 to 23 March 2011 and one from 24 March 2011 to 31 December 2011 for each of MONS and MOUK.

66. This led to the following apportionment of profits:

(a) MONS pre-March 24 period $110,649,392. Post March 24 period – NIL

(b) MOUK pre-March 24 period $77,033,308. Post March 24 period – NIL

67. In the Appellants' appeal notices this basis is described as "*allocating profits before and after the date of the change in tax rate in a way which most closely reflected the way in which the profits would have been apportioned had an accounting period actually ended on the date of the change in tax rate"*.

68. For MONS, this took account of the capital allowances claimed as a result of the damage to the Gryphon platform after the storm in February 2011, recognising this expenditure when it was incurred, in the second half of 2011. For MOUK, this took account of capital allowances relating to the "shut in" expenditure incurred during the latter part of 2011.

69. The result of applying this actual basis was that both MONS and MOUK generated no taxable profits in the period after 24 March 2011 and therefore none of their 2011 profits were subject to the increased rate of supplementary charge.

70. On behalf of the Appellants Mr Sykes said that there was no requirement that the Appellants should prove that their method was the *most* just and reasonable basis, only that it was a just and reasonable basis. The basis proposed was a "just and reasonable" basis to apportion the profits of both MONS and MOUK for the periods before and after the rate change in 2011.

The context of s 7(5)

71. Mr Sykes referred to the response of the oil industry to the sudden and unannounced introduction of the increased supplementary charge and explained that s 7(5) had been introduced in the context of protests from the oil industry about that sudden change and a request for a "just and reasonable" override. Mr Sykes took the Tribunal to a letter from the UKOITC to HMRC of 7 April 2011 saying:

> "*The strict time apportionment methodology provided for in the current Bill has the effect of imposing tax retrospectively. For example, if a company has disposed of a field interest this calendar year but before 24 March 2011 in a transaction that has resulted in a balancing charge, that charge should be subject to SCT at the lower 20% rate that prevailed at the time of the transaction. Instead the Finance Bill provisions would subject over 77% of this charge to tax at the new higher rate. This cannot be fair."*

72. It should therefore be assumed that the purpose of s 7(5) was to alleviate problems for companies with open accounting periods on 23 March 2011 and to avoid retrospective taxation.

73. A just and reasonable apportionment of profits required a "yardstick" to measure what the correct tax measure of profits should be for the two periods. Splitting profits into two deemed accounting periods ending on and beginning after 24 March 2011 was a rational way of apportioning the profits for the straddle period.

74. As a matter of statutory construction, the correct approach to s 7(5) is to treat the split periods as separate accounting periods. Splitting the periods before and after the rate change into two separate accounting periods was also consistent with the language of s 7(4)(a) FA 2011 which specifically refers to treating the two periods before and after 24 March 2011 as separate accounting periods and the approach adopted by s 93(1)(b) of the Finance Act 2002 on the introduction of the supplementary charge, which does the same:

"***S 93 Supplementary Charge: transitional provisions***

(1) *In the case of a straddling period, that is to say, an accounting period which begins before 17th April 2002 and ends on or after that date –*

(a) sections 510A and 510B of the Taxes Act 1988 (which are inserted by sections 91 and 92) shall apply as if so much of the straddling period as falls before 17th April 2002, and so much of that period as falls on or after that date, were separate accounting periods; and

(b) all necessary apportionments between the two separate accounting periods shall be made in proportion to the number of days in those periods"

The yardstick of just and reasonable

75. To determine a just and reasonable allocation of profits, some yardstick was required. Mr Sykes pointed out that it cannot be the case, as HMRC's approach assumes, that the "yardstick" for measuring whether a basis is just and reasonable is by reference back to time apportioned profits, since s 7(5) is only triggered if time apportionment is not just and reasonable.

76. A just and reasonable allocation of profits was best achieved by producing figures which resulted in what Mr Sykes described as "*economic events being translated into their tax measure*", being the "actual basis" applied by Mrs Ritchie, in which taxable profits had been allocated to each of the two periods on the basis of the taxable profits which would have resulted had they actually been two separate accounting periods. That approach was an intuitive, simple and obvious approach.

77. The Appellants' approach reflected the actual profitability of MONS and MOUK for the relevant period; both companies' accounts made clear that neither company had made profits for the post- 24 March 2011 period.

78. Mr Sykes referred to the decision in *Marshall Hus* to support this approach, that it is necessary to take account of the actual results for the relevant period to determine how any allocation of profits should be made:

> "*My own view is that if it is clearly possible to reach a more accurate and a fairer estimate of profit or loss, though not necessarily a perfect one, by some other route than apportionment, then apportionment is not "necessary" within the meaning of s 129*" Goulding J at p549.

79. Mr Sykes accepted that some elements of Mrs Ritchie's calculations had not been perfect but said that this did not mean that the overall basis applied was not just and reasonable.

Re-allocation or re-computation

80. In Mr Sykes' view, it was not correct to say that either MONS or MOUK had "re-computed" their profits as had been suggested by HMRC. In particular, the tables constructed by Mr Sherriff to show how the Appellants' approach resulted in more than 100% of the companies' profits being allocated to the pre-March 24 2011 period were not a correct reflection of what had been done.

81. The effect of applying the actual basis has impacted the apportionment of profits between the two periods, but in Mr Sykes' view a re-apportionment can include a reallocation of the components of the profit for the period. The reference in s 7(5) to a "basis of apportionment" suggests that the legislation is looking at principles of computation rather than just making individual adjustments to existing profits.

Comments on HMRC's approach

82. Mr Sykes suggested that HMRC's real issue was not with the use of the actual basis, but with the first year capital allowances being claimed in the post-March 24 2011 period. However, the capital allowances legislation permits first year capital allowances to be claimed even if an accounting period is less than twelve months long, by reference to the chargeable period in which the first year qualifying expenditure is incurred (s 6(1)(b) and s 52 Capital Allowances Act 2001).

83. Mr Sykes referred to examples elsewhere in the taxes acts where apportionment of profits to a short accounting period did not preclude the full amount of capital allowances being claimed and referred to HMRC's Oil Taxation manual which accepted this approach in the context of ring fenced oil profits "*As with other first-year allowances, the amount of the special ring fence first year allowances is not reduced even though the deemed accounting period is less than one year*" [OT21223].

84. Mr Sykes also referred to the guidance in HMRC's manuals concerning the measure of profits for group relief purposes under s 141(3) Corporation Tax Act 2010 which accepts that the measure of "just and reasonable" profits is by reference to the actual results of company for the relevant period and also accepts that management

accounts can be relied upon as a permitted alternative to time apportionment (at CTM80265).

85. The basis suggested by HMRC for re-apportioning profits was not reasonable, but was subjective and distorting. Mr Sykes said that HMRC had plucked figures from the companies' accounts and made adjustments by reference to those figures on the basis of no clear principle. HMRC's approach was not consistent; it did accept that some elements of the tax calculation needed to be separated out in order to give a "just and reasonable" apportionment; particularly the expenditure and insurance payments relating to the Gryphon incident, but other elements were left subject to time apportionment.

86. Mr Sykes also made the point that the question of whether there has been a "distortion of profits" as a result of the allocation of capital allowances as HMRC suggested, is a moral question which is outside the scope of the tax legislation, referring to statements made in the *Anthony Bayliss* decision:

> "*The tax system is highly complex and there are many instances where the calculation of a profit for tax purposes differs markedly from the economic profit or loss. In some cases the fisc benefits from the difference and in other cases it does not".* [61]

HMRC's arguments

87. On behalf of HMRC Mr Jones explained how the amended assessment issued to MONS and the closure notice issued to MOUK had apportioned profits.

MONS

88. HMRC accept that the Gyphon incident had an impact on MONS' trade for 2011, but it did not prevent MONS from trading and earning profits after 24 March 2011. HMRC's approach to re-allocating profits was intended to reflect the fact that MONS did not cease to trade after 24 March 2011 while also addressing the impact of the Gryphon incident.

89. Therefore HMRC's reallocation for MONS has been done by taking the income figure generated by MONS for the whole of 2011, after the claw back of capital allowances (the Property Damage Insurance payment) and before deductions, but without taking account of capital allowances claimed for the Gryphon incident. The resulting figure was then spread between the pre-4 February 2011 Gryphon incident period and the post 4 February 2011 period.

90. The Loss of Production Insurance payment had been spread across both the pre- and post-March 24 periods, because that payment related to the Gryphon incident which happened in the earlier period. The apportionment had been done by allocating the payment on a time apportioned basis for the period from 4 February 2011 (the

date of the Gryphon incident) to 23 March 2011 and the remainder to the post- 24 March period.

91. Capital allowances (net of the balancing charge relating to the Property Damage Insurance) which related to the Gryphon incident had also been time apportioned rateably as from 4 February 2011 to 23 March 2011. The balance of any capital allowances had been deducted for the post 24 March period.

92. In summary, HMRC have re-apportioned the income and deductions which they consider relate to the Gryphon incident for MONS between the periods (a) from the date of the incident to the date of the rate change and (b) from the date of the rate change to the end of the accounting period. This resulted in £49,119,635 of profits being apportioned to the pre-24 March period and £19,962,835 of profits being apportioned to the post-24 March period.

93. HMRC accept that MONS' trade suffered unexpected interruption as a result of the Gyphon incident but do not accept that the scope of this interruption supports a reallocation of profits entirely to the pre-24 March 2011 period.

MOUK

94. As for MONS, HMRC accept that the Janice FPU shut in did have an impact on MOUK's trade during 2011, but this did not prevent MOUK from earning profits in the post-24 March period. The Appellants' approach of allocating profits to the pre-24 March 2011 period is not a fair or accurate reflection of MOUK's activities for the post-24 March period.

95. For MOUK, HMRC have also applied an apportioned split of profits before taking account of capital allowances, because in their view the capital allowances skew MOUK's profits and do not reflect the fact that MOUK traded throughout 2011 with minimal disruption. The unexpected shut in of the Janice FPU resulted in only just over a month of unplanned interruption, but the Appellants have used this as a reason for reallocating all aspects of MOUK's profits for 2011, which is not just and reasonable.

96. In HMRC's approach, profits (including capital allowances) are allocated to the pre-and post-24 March periods by reference to MOUK's figures for turn-over and expenditure provided in its management accounts for 2011, placing 53% of profits in the pre-24 March 2011 period and 47% of profits in the post-24 March 2011 period. That resulted in $121,779,808 of profits being apportioned to the pre-24 March 2011 period and $108,158,045 of profits being apportioned to the post-24 March 2011 period to which the supplementary charge should be applied.

The context of s 7(5)

97. Mr Jones accepted that s 7(5) had been introduced as a result of oil industry lobbying after the change of the supplementary rate on 23 March 2011 and that it was intended to remove the risk of retrospective taxation, but stressed that in HMRC's view its scope was intended to be narrow and that it was intended to be used only in

exceptional circumstances, including the types of events referred to by the UKOITC in their lobbying letters to HMRC, but not in circumstances in which profits were uneven only as a result of a company's usual trading.

98. Mr Jones also argued that there was a difference between the way in which s 7(5) FA 2011 and s 93 Finance Act 2002 operated, the latter refers to the two periods being treated as if they "were two separate accounting periods" but s 7(5) uses different words, the two periods are to be "treated as if they were two separate accounting periods" and is not intended to allow companies to treat the two periods as if they were actually separate accounting periods.

The yardstick of just and reasonable

99. HMRC's review letters of 28 July 2016 set out the basis for their rejection of the Appellants' approach and their alternative approach, which is the same for both MOUK and MONS:

> "*Allocating individual items to separate periods within the year can itself have a distorting effect because, in apportioning profits of the year, it is important that income and expense which relate to the whole of the accounting year should not be attributed to a particular period within the year.....I do not consider that your alternative basis, which results in all the adjusted ring fence profits of the year being apportioned to the first 82 days of the accounting period is just and reasonable"*
>
> In the case of MOUK HMRC's letter added an explanation to this conclusion *"because it does not accurately reflect the economic reality, production profile, activities and circumstances"*
>
> In the case of MONS, HMRC's letter goes on to say *"That (HMRC's) basis does apportion considerably more adjusted ring fenced profits to the period before 24 March than would result from a strict time apportionment, reflecting the circumstances which led to much reduced profitability in the later part of the year"*

100. HMRC say that the concept of "just and reasonable" in s 7(5) is an "open textured one" but that the test should be applied to the result achieved by the basis used, not the reasonableness of the method per se.

101. The reasonableness of the apportionment has to be determined by reference to the relevant circumstances of the company, looking at the pattern of its profits for the relevant period and the factors which have meant that time apportionment would be unreasonable or unjust.

102. Furthermore, time apportionment was considered to be a reasonable default method to apply to oil extraction profits even though all companies involved in the oil trade suffer some degree of fluctuation in their profits. Normal profit fluctuations could not therefore justify a move away from a time apportionment method.

103. If there is a need for a yardstick or comparator, and HMRC suggests that this is not actually required by the legislation, the most natural comparator is the default, time apportionment method referred to in s 7(4).

104. HMRC reject the Appellants' reliance on the *Marshall Hus* case, saying that it considers the question of whether apportionment itself should be applied, rather than the question which is relevant to these Appellants, which is what method of apportionment should be used.

Re-allocation or re-computation

105. On behalf of HMRC Mr Jones said that HMRC's calculations were just and reasonable since they did what the legislation said was required, namely re-apportion profits. Mr Jones stressed that in the statutory context of s 7(5) it was clear that the starting point was to take the profits as already computed, and then re-apportion them. The reference in s 7(4) is to "*the adjusted ring fence profits for the straddling period"*, indicating that the starting point for the apportionment is the ring fence profits as already computed.

106. In his view, the Appellants had gone further and re-calculated their profits, as if s 7(5) gave them a blank sheet of paper and allowed the two periods to be treated as if they were actually separate accounting periods, moving away entirely from time apportionment.

107. Mr Jones also noted that the treatment of the straddling period as two separate periods in s 7(4) is for a specific limited purpose only, the apportionment of the already computed profits and not their recalculation.

108. Mr Jones said that because both MONS and MOUK had continued to make profits from their other fields during 2011, it was distortive to suggest that they should not be treated as generating any taxable profits at all in the period after 24 March 2011. This was particularly true of MOUK, whose business had only been disrupted by a longer than expected shut in period; the six weeks from mid-November to the end of December 2011, the period of the shut-in over run. MOUK had actually generated 62% of its turnover after 23 March 2011.

Comments on the Appellants' approach

109. HMRC object to the Appellants' approach to apportionment, treating the two periods as if they were in fact two distinct accounting periods, because the Appellants have departed entirely from a time apportionment method and have allocated profits and expenditure irrespective of whether the profits in question have any material link to the circumstances relied on to justify a move away from time apportionment.

110. The Appellants have proceeded on the basis that if they can identify one element of the adjusted ring-fence profits for which time apportionment would be un reasonable or unjust, then all of the profits for that period, rather than only those relating to a specific incident (the Gryphon incident or the Janice FPU shut in) can be adjusted on a non-time apportioned basis, but that is not how s 7(5) operates.

111. The allocation method used by the Appellants is a re-calculation not a re-allocation and relies on treating the two periods as if they were actually two separate accounting periods which is not what the language of s 7(4) and (5) indicates is required.

Discussion and decision

Findings of fact

(i) Mrs Ritchie used an accruals basis to prepare monthly management accounts and reports for MONS and MOUK.

(ii) Mrs Ritchie used the accruals figures produced by MONS and MOUK's monthly management accounts to provide the "actual basis" on which she submitted MONS and MOUK's tax returns for the 2011 accounting period, including taking account of capital expenditure at the date when it was incurred.

The context of s 7(5)

112. I have accepted Mr Sykes' statement of the purpose of s 7(5) FA 2011, including taking account of the comments made by those in the oil industry at the time when the sudden change in the rate of the supplemental charge was introduced.

113. It is intended to provide relief for companies whose profits are not smoothly spread throughout the year, but whose profits differ greatly from one part of the year to the other, and who could be disadvantaged by such a change of tax rate part way through an accounting period. The legislation recognises that a time apportionment method will work fairly for smooth profits, but it will be potentially unfair for lumpy profits.

114. In accepting that both MONS and MOUK could make an election under s 7(5) HMRC have accepted that their profits are sufficiently irregular to give rise to a disadvantage.

115. HMRC did not dispute the purpose of s 7(5) FA 2011, but only its intended scope.

Yardstick of just and reasonable

116. The question in this appeal boils down to how to deal with profits which are not smooth in a way which is just and reasonable, and particularly how to deal with the lumpiness caused by events giving rise to capital expenditure.

117. It is worth noting at this stage that the first year capital allowances with which we are mainly concerned here are intrinsically lumpy, that is, they are available on an incurred basis as set out in s 52 Capital Allowances Act 2001.

118. Both parties suggested that their approach produced the most just and reasonable apportionment of profits between the two periods and that the other party's approach had a "distortive" effect.

119. My view is that both parties have fallen into the trap of attempting to establish that there is a method (or basis) which will perfectly align economic profits with how and when they are taxed. That is a chimera, as was suggested in the *Anthony Bayliss* case to which Mr Sykes took the Tribunal. In fact, all that is required for s 7(5) FA 2011 purposes is for profits to be taxed by reference to a basis which is neither unreasonable nor unjust.

120. HMRC have also fallen into the trap of conflating basis and result. Mr Jones attempted to argue that the just and reasonableness of a basis used under s 7(5) could only be judged by reference to the results produced in the case of a particular company. HMRC's main issue with the Appellants' approach seems to be less the basis which has been used, but more the fact that it results in all of the Appellants' profits being moved out of the higher tax period.

121. Asking whether a method produces a just and reasonable result is one way of testing whether a method is just and reasonable; but a method is not necessarily unjust and unreasonable only because it produces a result which may not align with one party's preferred result.

122. It is inevitable in a case like this that comparisons are made between the two methods suggested by the opposing parties, but in fact, all that is required by the legislation is that the alternative method of apportionment utilised by the taxpayer is "a basis that is just and reasonable". If the taxpayer's approach is just and reasonable, the fact that HMRC's approach might be said to be better, or more just and reasonable, is not relevant.

123. Contrary to the suggestions made by Mr Sherriff in his witness statement, it is also my view that the apportionment method applied by the Appellants does not have to be more just and reasonable than a simple time apportionment. HMRC have accepted that simple time apportionment will work unreasonably for both MONS and MOUK, The only requirement of the legislation is that the alternative basis of apportionment for which the Appellants have elected is itself just and reasonable.

Re-allocation or re-computation

124. The Appellants' re-allocation of profits for the pre-and post-March 24 2011 periods has moved away completely from any suggestion of time apportionment, leading HMRC to suggest that what has been achieved is a wholesale re-calculation of profits rather than a different basis of apportionment.

125. I do not accept that there is a complete distinction between the concept of apportionment and the concept of calculation; there is a place where the two overlap, and one of those places is in deciding when capital expenditure should be treated as incurred for tax purposes. For this reason, I do not accept Mr Jones' interpretation of the legislation's reference to the "re-allocation of adjusted ring fence profits" as excluding any element of re-calculation.

126. Nor do I accept that Mrs Ritchie's approach goes further than is envisaged by the legislation in calculating profits by reference to two actual accounting periods rather than the "deemed" separate accounting periods referred to in s 7(4) FA 2011. This element of Mr Jones' argument seems to be to be a proxy for his arguments that capital allowances should be spread across the whole period rather than allocated to the period in which they were incurred.

127. To my mind there is no discernible difference between the wording of s 93 Finance Act 2002 and the wording of s 7(4) FA 2011 and nothing in s 7 FA 2011 which suggests that what Mrs Ritchie did was outside the scope of that provision; treating the pre-and post March 24 2011 periods as if they were actually separate accounting periods.

128. However, I also accept that Mrs Ritchie's solution is less than perfect; she accepted that there were some imperfections in her approach and that it could have been further refined.

Just and reasonable - HMRC's approach

129. HMRC say that the Appellants' wholesale rejection of time apportionment is not "just and reasonable" because it fails to properly reflect the fact that both companies continued to undertake profitable activities after 24 March 2011.

130. Equally, in HMRC's model, any move away from time apportionment is "just and reasonable" only by reference to some kind of "force of attraction" argument, with profits strongly related to particular events being non-time apportioned, while other elements of the companies' profits remain time apportioned.

131. I do not agree that HMRC's allocation, based on the companies' profits before taking account of capital expenditure and by reference to time apportionment as its reference principle is the only "just and reasonable" basis on which the Appellants' profits can be apportioned for the purposes of s 7(5) FA 2011.

132. My view is that HMRC's adherence to time apportionment as part of an alternative "just and reasonable" basis of allocation is not merited by the terms of the legislation which, as Mr Jones described it, is "open textured" as would be expected of a "just and reasonable" provision

133. Mr Sherriff explained that this alternative basis proposed by HMRC was intended to be the basis of a negotiated settlement, rather than a true theoretical alternative to the time apportionment which he said in retrospective he believed was

the only just and reasonable basis for apportioning both MOUK and MONS's ring fenced profits.

134. As a result, HMRC's alternative approach to a "just and reasonable" allocation of profits appeared to me to produce something of a hybrid answer to the question of what a just and reasonable apportionment of MONS' and MOUK's profits might be.

135. S 7(5) FA 2011 refers to a "basis" of allocation. This to me suggests that the legislation envisages something more than the slightly amended version of time apportionment suggested by HMRC and can include something which starts from a different principle, including a basis such as the "actual" basis applied by Mrs Ritchie.

Conclusion

136. Mrs Ritchie appeared to me to be a reliable witness who had made a genuine attempt to produce an allocation of taxable profits in line with the requirements of s 7(5) and by reference to a profit allocation method with which she was familiar and was already being used for internal reporting purposes. As she said "*an apportionment based on the Appellants' actual profits per month [was] the most natural alternative*".

137. It would be difficult to suggest that her analysis in the case of either MONS or MOUK was unreasonable.

Reasonable basis

138. I have concluded that the actual basis applied by Mrs Ritchie as the basis for MONS and MOUK's corporation tax calculations for the 2011 tax year is a reasonable basis of apportioning the companies' ring fence profits under s 7(5) FA 2011. I have come to this conclusion accepting that it has some shortcomings but also bearing in mind that:

139. (i) It is a method which is closely aligned to the method used by Mrs Ritchie for management accounting and reporting purposes; it is not a contrived method.

140. (ii) It relies on a consistent concept which has been applied (with minor errors) by Mrs Ritchie to both income and expenditure, which has not always worked in the Appellants' favour.

141. (iii) It is in line with the statutory context of s 7 FA 2011 which envisages treating the pre-and post March 24 2011 periods as separate accounting periods.

142. (iv)While not perfect, it provides a reasonable reflection of the financial results of the two companies for the relevant periods, including significant capital expenditure.

143. (v) It reflects the fact that first year capital allowances are not given on time apportioned basis, but on an incurred basis.

144. (vi) I have also taken account of the other examples referred to by Mr Sykes in which HMRC have accepted that first year allowances do not need to be time apportioned when accounting periods have been truncated.

Just basis

145. It seems to me that HMRC's main concern has been with the justness of the result of the application of Mrs Ritchie's method, because it has led to all of the profits of both companies being allocated to the low tax period prior to 24 March 2011.

146. I have also concluded that Mrs Ritchie's basis for attributing the profits of MONS and MOUK for the two periods before and after 24 March 2011 is just. I have come to this conclusion because:

147. (i) The context of s 7(5) is to solve a perceived unjust result. While the method adopted by the Appellants might not be perfect, it does provide a reasonable alternative to a time apportionment approach which answers the requirement of the legislation.

148. (ii) HMRC suggested that the Appellants had applied a contrived method to intentionally distort their profit profile. I do not accept this either in principle; the actual method was not contrived and was the one regularly used by Mrs Ritchie in her monthly financial reporting, or in practice; Mrs Ritchie allocated both income and expenses by reference to the same method, whether or not this gave rise to an advantage or a disadvantage for MONS or MOUK.

MONS and MOUK

149. I have considered whether this conclusion should be the same for both MONS and MOUK, it being undoubtedly the case that MONS suffered a more significant disruption to its ring-fenced trade in 2011.

150. Albeit rather late in the day, HMRC accepted that MOUK could also make an election under s 7(5) FA 2011 and therefore it does not seem to me to be open to HMRC to argue that MOUK should nevertheless be taxed on a basis which is only one remove from full time apportionment.

151. Much of HMRC's arguments in respect of MOUK seemed to me to really be an attempt to argue that MOUK's profits were not in fact very lumpy. But having accepted that MOUK's profits are sufficiently irregular to allow it to make the s 7(5) election, it does not seem to me that degrees of lumpiness are relevant, as long as the alternative basis suggested by MOUK is just and reasonable.

152. I have therefore concluded that the same approach should be accepted for MOUK as for MONS. If Mrs Richie's approach is just and reasonable for MONS, it is also just and reasonable for MOUK.

153. For these reasons these appeals are allowed in respect of both MONS and MOUK.

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

Rachel Short
TRIBUNAL JUDGE

RELEASE DATE: 9 January 2018