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CLIENT BRIEFING

FEBRUARY 2025

The Court of Appeal in *ScottishPower* determines that a package of redress payments put together under a threat of a penalty imposed by the energy regulator is not itself a penalty and is not prohibited from being deductible under the rule against deduction of penalties. HMRC publishes supplementary draft guidance on the MTT and DTT which includes guidance specific to the insurance sector. The latest HMRC statistics on transfer pricing and DPT show that HMRC believe that DPT has secured more than £8.7bn of additional revenue since being introduced up to the end of the 2023-2024 tax year.

ScottishPower: payments in lieu of penalties may be deductible

ScottishPower Ltd and others v HMRC [2025] EWCA Civ 3 is a case about the deductibility in computing trading profits of payments made in connection with investigations by the energy regulator, GEMA, into regulatory breaches by the taxpayers which carried on energy supply businesses. Each investigation resulted in a settlement comprising a number of redress payments to consumers, consumer groups and charities and a nominal £1 financial penalty. Across all the settlements the payments totalled around £28m, but only the nominal penalties were considered by GEMA to be actual penalties and accordingly paid into the Consolidated Fund. The First-tier Tribunal (FTT) had concluded that had the taxpayers not made the settlement agreements, it was likely that penalties of at least the same amount would have been imposed.

This case is one where the reasoning and outcome has differed at each stage of proceedings. The FTT had concluded that payments of around £0.5m made directly to customers affected by mis-selling were compensatory, not punitive, and were wholly and exclusively for the purposes of the taxpayers' trade and so were deductible.

The Upper Tribunal (UT), on the other hand, looked at the payments as a whole and concluded that the FTT was wrong to single out part of that package as compensatory when all of it was punitive and therefore non-deductible. The UT reasoned that the overall package had been put together under the threat of a penalty and was paid in lieu of a penalty. The UT accordingly remade the FTT's decision with the result that all the payments were non-deductible.

The Court of Appeal took the view that apart from the £1 nominal penalties, the payments made by ScottishPower, whether compensatory or not, were not themselves penalties. It did not matter that the level of the penalties was reduced to reflect the other payments ScottishPower agreed to make as part of the settlement and that the payments effectively replaced the penalties. GEMA had no power to redirect payment of penalties to third parties: any penalties had to be paid into the Consolidated Fund.

HMRC's argument was that the disputed payments in this case should be treated as having the same nature or character as penalties because that is what they replaced. The Court of Appeal reviewed the case law (in particular the *von Glehn* case [1920] 2 KB 553) establishing that a penalty or fine incurred under a statutory regime is not deductible in computing trading profits because to permit such a deduction would dilute the effect of the penalty. The Court of Appeal concluded that for this rule to extend to amounts which are not fines or penalties but which are substitutes for such fines or penalties would bring uncertainty into the rule. In any event 'No authority was cited to support any general proposition that the deductibility of a payment should be determined by reference to the nature of a payment which it replaces.'

The reluctance of the Court of Appeal to treat payments in lieu of penalties as penalties (which is what the UT did) may seem odd when we are used to seeing the courts take a strong 'substance over form' approach in tax cases but is explained by the need to avoid the uncertainty which would be introduced into the judge-made rule if payments made instead of penalties were also treated as non-deductible. It is an important case for taxpayers whose settlement amounts may have been agreed on the basis that there would be a deduction for such payments in lieu of penalties.

It is worth remembering, of course, that there is an extra restriction on deductibility for banks since the deduction

for many compensation payments made by banks was turned off by statute (CTA 2009, s133A) in 2015.

HMRC's supplementary draft guidance on MTT and DTT

The Trump Administration has made it clear there is no support in the US for the (in the words of the Congressional Republicans) 'global tax surrender' of the OECD's two Pillars of tax reform and indeed is reviewing its options for retaliation against foreign nations that seek to impose the undertaxed profits rule (UTPR) and other 'extraterritorial' or 'discriminatory' taxes on US businesses. In the UK, however, the staged roll out of the implementation of Pillar 2 continues. The latest Finance Bill includes provisions to implement the UTPR and to make changes to ensure the MTT/DTT legislation works as intended and keeps up with the OECD's Administrative Guidance.

Although the UK's UTPR has effect for accounting periods beginning on or after 31 December 2024, the UTPR safe harbour operates to delay start of UTPR for one year in relation to untaxed amounts in certain ultimate parent entity jurisdictions (such as US) where there is a minimum rate of tax of at least 20% (looking at the headline tax rate not the effective tax rate). One possible concession to the US would be to extend this UTPR safe harbour until after the next US election!

The legislation in Finance (No.2) Act 2023, as since amended and as it will be further amended after the latest Finance Bill changes, is highly complex and technical so HMRC's guidance will be a useful tool to help business and advisers see the big picture of how the interlocking rules are intended to work and to see HMRC's explanation of how the detail of the legislation is intended to work in practice.

HMRC has published supplementary draft guidance on the MTT and DTT for consultation until 8 April which includes guidance on the UTPR, Joint Venture groups, flow-through entities and, in Annex A, guidance for the insurance sector. Where changes are made by the Finance Bill affecting these topics, the guidance explains the new rules although further changes to the guidance may be made as a result of government amendments to the Finance Bill. There are no changes to the specific parts of the MTT/DTT rules which apply to the insurance sector, but Annex A of the guidance helpfully explains the specific exclusions and adjustments that are required to be made to ensure the rules work properly for insurance companies.

The promised map between the legislation and the OECD Model Rules and a reverse map will be added to the guidance manual before it is published in full in late spring, after the Finance Bill has received Royal Assent. The manual will continue to be work in progress and subject to further improvements as the rules bed down and as HMRC responds to requests for clearances and queries.

Transfer pricing and diverted profits tax statistics 2023-2024

HMRC published their latest Transfer Pricing and Diverted Profits statistics on 27 January and they are worth picking over. For starters, they show an increase to 27 in the number of advance pricing agreements (APAs) agreed in the year, compared with just 15 the previous tax year. The average time to reach agreement has increased, however, from 45 months to 53 months. It will be interesting to see if the Court of Appeal's decision in *Refinitiv* [2024] EWCA Civ 1412 (discussed in last month's Tax and the City Review) deters taxpayers from seeking APAs this year! The APA numbers do not include advance thin capitalisation agreements (ATCAs) where there has been a significant fall in numbers from 2018-19 when 59 ATCAs were agreed and 255 were in force to 2023-24 when only 10 were agreed and 27 in force. HMRC attribute the fall to the introduction of the UK's corporate interest restriction in 2017. It is interesting to note that despite significant drop-off in number of ATCAs agreed, as with APAs the time taken to reach agreement has increased. From 26.3 months in 2018-19 to 37.3 months in 2023-24 (though down on 2022-23's 58 months!).

On the subject of time taken to reach agreement on something, our recent experience on transfer pricing enquiries for large businesses has been that they are taking longer than ever. We can think of several where HMRC is still requesting information in relation to transactions that took place, and enquiries opened, the best part of a decade ago and which show no sign of reaching a conclusion any time soon. Any group involved in such an enquiry will no doubt have a wry smile at the following quote:

> 'The United Kingdom resolved transfer pricing cases on average within 25 months, continuing to outperform the global average resolution time of 32 months for resolving transfer pricing cases.'

That must be what statisticians refer to as the 'tyranny of averages'!

The Profit Diversion Compliance Facility (PDCF) continues to prove successful for HMRC with about two-thirds of the large businesses targeted choosing to bring their tax affairs up to date using the facility. In 2022 to 2023, HMRC issued just two PDCF letters as it concentrated resources on the progression and conclusion of cases already within the facility. It is not that surprising, therefore, that in 2023-2024 there were 19 PDCF letters issued. The latest statistics show that over £830m additional revenue has been secured under the PDCF and through changes in customer behaviour since the PDCF was introduced in 2019.

According to HMRC, diverted profits tax (DPT) has secured more than £8.7bn of revenue since being introduced up to the end of the 2023-2024 tax year. It is unsurprising, therefore, that the proposals to modernise transfer pricing and DPT do not simply abolish DPT but bring it within the corporation tax rules in order to continue to change

behaviour. DPT is, however, one of the 'extraterritorial' foreign taxes on the radar of the Trump Administration which could lead the US to push back with a reciprocal tax on the US income of certain UK investors so it will be interesting to see if this has any impact on the UK government's commitment to retain DPT within the corporation tax rules. Those practising tax in 2015 will likely remember that it was christened 'Google tax' by the media on introduction.

It is also interesting to unpack how HMRC have arrived at their £8.7bn number in a bit more detail. £6.5bn is from the period 2018-2024, for which more detailed statistics are provided. Of that £6.5bn, only £500m is DPT itself, spread largely over the last 4 years. Somewhat surprisingly (to us, at least) almost 40% of that number, nearly £2.5bn, is made up of 'additional VAT from business restructuring', almost all prior to 2020. Less surprising is the fact that the £3.5bn balance largely comes from additional corporation tax from transfer pricing adjustments made as a result of DPT investigations. There was a reason why our former partner Steve Edge used to refer to DPT as 'transfer pricing with brutality'.

Finally - and perhaps we are just feeling a little sensitive at the start of the year! - it seems to us there is a slightly menacing undertone in this publication. It starts with noting that HMRC is investigating not only taxpayers who registered for PDCF but whose proposals were rejected but also 'most multinationals that received PDCF letters and choose not to register' - i.e. if you receive a PDCF letter and do not register expect an enquiry anyway. But it ramps up at the end with the warning that:

> 'If HMRC have major concerns about the way that arrangements to divert profits have been implemented, and/or suspicions that we have been misled, we refer our concerns to colleagues in Fraud Investigation Service in accordance with our standard procedures. There are a number of large businesses under civil or criminal investigation with HMRC's Fraud Investigation Service.'

Perhaps that is just clumsy wording but that suggests HMRC would consider involving the Fraud Investigation Service in circumstances where they do not suspect they have been misled which one might think ought to be a perquisite for such a referral.

What to look out for:

- The Public Bill Committee completed its review of the Finance Bill and the amended Bill was reprinted on 3 February. The Bill will continue through its remaining stages in the coming weeks.
- The EU Tax Symposium to discuss the future of tax systems in the EU takes place on 18 March under the theme of 'Strengthening competitiveness and fairness to build prosperity'.

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