Tax and the City Review

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It is 'business as usual' following exit day according to the EU Withdrawal Agreement (at least for matters covered by the agreement) and the government sets out its post-Brexit ambitions and priorities for the financial services sector. HMRC publishes further guidance on the interpretation of the hybrid capital instruments rules. The Upper Tribunal in *Hicks* finds that the taxpayer's accountant was careless in completion of his tax returns and that the conditions for HMRC to raise a discovery assessment are met. Progress is made on the two pillars of international tax reform, with the agreed outline on Pillar One noting that there is a compelling case for retail banks and insurance to be outside the scope of the new taxing right. The latest HMRC statistics show, unsurprisingly, diverted profits tax receipts are down on last year but they also reveal that HMRC has concluded a number of older transfer pricing cases.

Post-Brexit: fish and financial services

Following the UK's exit from the EU on 31 January, we are now in the 'business as usual' transition period provided for in the Withdrawal Agreement. Under that agreement, until 31 December 2020, everything stays the same as far as the UK and the EU are concerned.

However, it is just worth bearing in mind that technically the UK ceased to be a Member State on 31 January and article 127(6) of the Withdrawal Agreement only provides for references in Union law, including as implemented and applied by Member States, to include the UK during the transition period. This means that, even during the transition period, if you are looking at a particular tax treatment which depends on the UK being a Member State, it will be necessary to consider whether the UK should be treated as a Member State for that purpose or not. Clearly the UK should be a Member State for provisions of EU law like the parent-subsidiary and interest and royalties directives. But it may not be a Member State for the purposes of the limitation of benefit clauses in tax treaties between the US and various other territories, for example.

It is also less clear whether the UK would be treated as a Member State for the purposes of domestic provisions of (other) Member States which refer to Member States and which are not obviously implementations of EU law themselves. For example, in some countries, on a share-for-share takeover, corporate shareholders only get rollover if the issuer is resident in a Member State. Query whether the UK would be treated as a Member State for those purposes during the transition period or not. Something to bear in mind over the next 11 months.

The future trade deal with the EU and with other main trading partners is now the key focus. Negotiations will be difficult and will inevitably require compromises and concessions. Ireland's prime minister, Leo Varadkar, has already suggested that London could lose access to European markets unless the EU has fishing access to UK coastal waters. Last year's political declaration between the UK and the EU on future relations stated agreements on both fish and finance issues were priority areas which should be settled by July. The EU has made it clear, however, that although assessment of whether to grant market access to UK-based firms through equivalence will begin 'immediately', decisions will be linked to the outcome of the overall trade talks.

In a letter dated 27 January, John Glen, Economic Secretary to the Treasury, set out the government's ambitions and priorities for the financial services sector which include balancing regulatory autonomy with market access and working with the EU to build a stabilised equivalence regime (one in which equivalence determinations cannot be easily withdrawn). This was reinforced by the Prime Minister's written parliamentary statement on 3 February.

Hybrid capital instruments: further guidance

HMRC has published further guidance (added to its *Corporate Finance Manual* at CFM37840, CFM37850 and CFM37870) on the interpretation of the hybrid capital instruments (HCI) rules which replaced the regulatory capital securities regime from 1 January 2019. An HCI is a loan relationship under which the debtor (but not the creditor) is allowed to defer or cancel interest payments but which has no other 'significant equity features', including that it not be convertible, otherwise than into shares in the debtor or its quoted parent in 'qualifying cases' only.

HMRC sets out its interpretation of the requirement in CTA 2009 s475C(1)(a) that in order to be an HCI there must be provision under which 'the debtor is entitled to defer or cancel interest' (see CFM37840). One defensible interpretation of these words might be that 'entitled' means 'able to cancel or defer without being in breach' rather than 'able to choose whether or not to cancel or defer' but HMRC have taken the latter view. HMRC's interpretation requires the debtor to have discretion to cancel or defer interest at any time, not just when certain conditions are met. So any instruments which merely provide for mandatory cancellation or deferment will not, under HMRC's view, be HCIs. This should not be a problem for new Tier 1 instruments, however, as they include provision for discretionary cancellation.

Under the heading of 'Distributions and special securities' in CFM37850, a new section has also been added on 'Entitlement to defer or cancel interest', this time dealing with CTA 2009 s420A. S420A switches off distribution treatment for amounts which would otherwise be treated as distributions under CTA 2010 s1015(4) because of the existence of the provision(s) entitling the debtor to defer or cancel interest. The guidance clarifies that the ability to defer a payment of interest on a loan relationship will not ordinarily result in any amount payable being regarded as a distribution. Without s420A, however, the ability to cancel a payment of interest may ordinarily result in an amount payable being regarded as a distribution. The guidance explains that s420A(3) ensures that if an instrument qualifies as an HCI (so it has the required discretionary entitlement to cancel/defer interest) any cancellation or deferral of interest (whether mandatory or discretionary) should be disregarded when considering if amounts payable in respect of the HCI are distributions.

Other areas covered by the latest guidance include:

- alternative deadlines for elections (as brought in by SI 2019/1250);
- conversion events (reflecting amendments brought in by SI 2019/1250);
- small redemption premiums and prescription clauses;
- updated guidance on 'interaction with hybrid mismatch rules' following SI 2019/1251 and SI 2019/1345.

Hicks: discovery assessments and carelessness of adviser

HMRC v Hicks [2020] UKUT 0012 (TCC) concerns discovery assessments under TMA 1970, s29. Mr Hicks had taken part in a tax loss scheme. The loss had been claimed in his 2008/2009 return and then carried forward and set off in the 2009/2010 and 2010/2011 returns. HMRC raised an assessment for 2008-09 to deny those losses and Mr Hicks did not appeal against this, so the substantive issue is not disputed. HMRC then raised a discovery assessment

into the 2009/2010 and 2010/2011 returns after the enquiry windows were closed.

The FTT had previously found that, although the discovery assessments were valid, HMRC had not shown carelessness by Mr Hicks or 'a person acting on his behalf' for the purposes of s29(4) in respect of the 2009/10 and 2010/11 years and also that the condition in section 29(5) was not met in relation to the 2010/11 income tax year because sufficient information had in fact been supplied to HMRC so as to alert the 'hypothetical' officer of the potential insufficiency in the original assessment.

The Upper Tribunal (UT) allowed HMRC's appeal in relation to section 29(4). This meant it was unnecessary for the UT to consider the application of s29(5) but it did so anyway and concluded it would have reached the same conclusion as the FTT (that enough information had been disclosed for the hypothetical officer to have been aware of the insufficiency in relation to 2010/11).

In relation to section 29(4), the UT found that the FTT had erred in law in its evaluation of whether Mr Bevis, Mr Hicks' accountant, had been careless. The UT found Mr Bevis was careless in relation to the completion of the relevant tax returns on behalf of Mr Hicks because he had failed to investigate Mr Hicks' trading status before including expenditure as trading expenses in the returns.

This case serves as a warning to tax advisers that the standard of conduct required of an adviser to avoid being careless for the purpose of s29(4) is high, even where the adviser is not familiar with the particular area of tax which is being advised on. If Mr Bevis had made it clear that he was not qualified to offer Mr Hicks any advice or recommendation as to his participation in the scheme or as to completion of the relevant parts of the returns, Mr Hicks would know he could not rely on Mr Bevis. Mr Bevis did not make this clear (in fact, he advised Mr Hicks that the scheme had the best chance of success and said he would enter it if he were him) and so took on the role of giving tax advice. Having taken on this role of giving tax advice, Mr Bevis gave advice which the UT found a reasonably competent tax adviser could not have given as to the deductibility of the expenditure and, similarly, he failed to give the advice which a reasonably competent tax adviser ought to have given to the effect that the expenditure was not deductible.

OECD: international tax reform - carve out for financial services

The latest statement of the Inclusive Framework (IF) provides an update on the progress of discussions on the two-pillar approach to address the tax challenges arising from the digitalisation of the economy and confirms commitment to reaching agreement by the end of 2020. An outline of the architecture of a unified approach on Pillar One has been agreed and good technical progress has been made on Pillar Two although both Pillars have significant technical challenges and critical policy differences still to be resolved. Good news from a financial services perspective is that it looks like most financial services will not be in scope of the new taxing right (Amount A).

The outline shows that the in-scope businesses for Amount A have now been split into two categories:

- automated digital services (provided on a standardised basis to a large population of customers or users across multiple jurisdictions such as online search engines, social media platforms and online advertising) but excluding services which might be delivered online but involve a high degree of human intervention and judgment (such as legal, accounting, architectural, engineering and consulting services); and
- consumer-facing businesses that generate revenue from the sale to consumers of goods and services such as computers, mobile phones, cars, clothes, luxury goods, branded food and refreshments, and franchise models (such as licensing arrangements involving the restaurant and hotel sector).

The outline confirms carve-outs for extractive industries and other producers/sellers of raw materials and commodities, and airline and shipping businesses. It acknowledges that most activities of the financial services sector take place with commercial customers and will therefore be out of scope but notes that there is a compelling case for consumer-facing business lines within the financial services sector, such as retail banks and insurance which are highly regulated in the market jurisdiction, to be excluded from the scope. Consideration might be given to whether any unregulated elements of the financial services sector require special consideration, such as digital peer-to-peer lending platforms.

Transfer pricing and diverted profit statistics

HMRC's recent press release boasts that more than £5 billion has been secured after a crackdown on multinational companies diverting profits, thanks to the diverted profits tax (DPT) rules. It is evident, however, from the 'Transfer pricing and Diverted Profits Tax statistics, 2018/19' released on the same day, that the introduction of DPT and the use of the Profit Diversion Compliance Facility have resulted in transfer pricing conclusions being reached in a number of older cases. This shows that part of the £5 billion is not actually a result of bad profit diverting behaviour by MNCs, despite the headline. The average age of settled transfer pricing enquires for the 12 months to March 2019 was 33.1 months (up from 24.7 months the previous year). HMRC is channelling resources to bring some of the oldest cases to a full and final conclusion.

The DPT yield for 2018/2019 is £12m, down from £219m in 2017/18. This is unsurprising as most groups will want to ensure they pay corporation tax at 19% rather than DPT at 25%. DPT notifications received by HMRC from groups within scope of the DPT legislation has also fallen to 59 (from 73). DPT charging notices were issued by HMRC to 13 customer groups (down from 22 in 2017/18). The press release states HMRC is currently carrying out around 100 investigations into diverted profits arrangements by multinationals.

What to look out for:

- The transfer pricing guidelines chapter on intragroup financial transactions is expected to be published on 11 February.
- On 20 and 21 February, the Upper Tribunal is scheduled to hear the appeal in *Vermilion Holdings Limited v HMRC* on whether an option granted to a company's director is an employment-related securities option.
- The Court of Appeal is scheduled to begin hearing the taxpayers' appeals in *HMRC v Investec Bank Plc & Investec Asset Finance Plc* (on partnership investments) on 3 or 4 March.
- The Upper Tribunal will begin to hear HMRC's appeal on 26, 27 or 28 February 2020, against the FTT's decision in *SIPPchoice* that HMRC was wrong to refuse to allow a SIPP provider to claim relief from income tax at source in respect of in specie contributions made by one of its members.

- HMRC has been asked by the Treasury to evaluate the implementation of its powers and safeguards introduced since 2012. A forum (which includes the Law Society and the ICAEW) has been gathering evidence from taxpayers of their experience of the most commonly encountered powers which include the power to 'name and shame' under the Bank Code of Conduct and the power to issue a DPT charging notice. It will be interesting to see the evaluation report in due course.
- The Chancellor will deliver the Budget on 11 March.

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