Contentious tax in 2017

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2017 has been a contentious year on many fronts – from announcing the wrong Oscar winner to the rather more serious Brexit negotiations – and things have been no less challenging for businesses attempting to resolve their tax disputes. In part, that reflects the way the media landscape remains hostile to anyone not paying their 'fair share' of tax (whatever that may be), which is a sentiment unlikely to lessen with the steady supply of 'offshore revelations', such as from the Panama and Paradise papers and law firms' leaks, or the anti-business momentum of certain parts of the political spectrum. However, many of the difficulties relate to the application of new legislation or powers to transactions or arrangements implemented some time ago. That after-the-event challenge is perhaps easier to understand for more obviously mass-marketed tax planning schemes but less so with long-standing commercial operations, especially when explaining this retrospectivity to senior executives. In this year-end piece, therefore, the intention is to pick out some of the principal themes and issues from 2017 and potential lessons for taxpayers for whom resolving tax disputes remains on the 'to do' list for 2018.

Transfer pricing and DPT

Of all the areas where new rules applied to old arrangements have led to an increase in tax disputes, the diverted profits tax (DPT) stands out as a priority for HMRC and a challenge for large business. While never welcomed, the upfront payment aspect of the regime - £138m of DPT already collected from the first wave of charging notices – is perhaps less difficult in practice than the tight timeframe: this gives twelve months but in practice less, given HMRC's governance timetable to resolve the underlying issues that lead to a DPT charging notice before the spectre of double tax becomes real. In our experience, that challenge is exacerbated by four factors.

First, in many instances DPT is being applied in relation to arrangements outside the UK that have real substance, were established long before DPT was contemplated or the tax treatment of which has previously been agreed with HMRC. That makes it particularly hard for many businesses to understand (or accept) there should be additional tax now.

Second, at a more technical level, the interplay of the DPT regime and any transfer pricing adjustment to 'fix' the DPT issues is complex and doesn't always provide a way out. For instance, much will depend on what HMRC accepts as being the 'relevant alternative provision' for DPT purposes and whether this can be reconciled with any transfer pricing adjustment in the DPT review period.

Third, even if transfer pricing can provide a solution, the post-BEPS landscape means taxpayers may need to undertake a significant review of their overall group pricing strategy. That must take into account not only the immediate challenge of a DPT inquiry but also the implications for operations in other jurisdictions, particularly outside Europe (where the adoption of post-BEPS OECD guidance is more varied).

Fourth, perhaps understandably, HMRC is still developing its preferred approach to handling DPT cases, which in some instances has led to inefficiencies and frustration for taxpayers. On the one hand, in some cases (and in the revised Litigation and Settlement Strategy (LSS)) it is clear that it's important to HMRC to 'establish' the facts

sooner itself, including requiring large scale email reviews and witness interviews with senior management, and that it will need this to satisfy the various internal approval panels or boards. On the other hand, this is simply not appropriate in all cases, so any 'levelling up' in the procedures can mean disproportionate time spent by taxpayers and HMRC on relatively trivial elements of the factual analysis. Nonetheless, given the tax at stake, businesses have rightly committed significant time and cost in 2017 to the technical and factual issues raised by DPT and transfer pricing disputes. Frustrating as it will continue to be for many business leaders, this looks set to continue in to 2018, albeit with the hope that HMRC will focus most on the 'contrived arrangements' stated to be the main policy objective of DPT rather than taking on genuine commercial activities.

Judicial review

Though absolutely right that HMRC should use the full range of powers available, it is also unsurprising that taxpayers have challenged the scope and application of those new powers. That has led to an increase in the number of tax-related judicial review cases. These have covered DPT (*Glencore* [2017] EWCA Civ 1761), reliance on HMRC guidance (*R Hely-Hutchinson* [2017] EWCA Civ 1075) and mistakes by HMRC (*Clarke* [2017] UKUT 379), as well as a number on accelerated payment notices and follower notices (such as *Rowe* and *Walapui* now with the Court of Appeal or *Dickinson* on the way there). Mostly, HMRC has been successful, with taxpayers facing particular difficulties getting past the fact there is often a 'suitable alternative remedy' other than judicial review through HMRC's internal process or the statutory review process or the need to show specific reliance on whatever HMRC has done or said in guidance. The recent *Broomfield* case ([2017] EWHC 2926) shows there are limits (legally and territorially) on HMRC, but the overall message for taxpayers from 2017 is that judicial review is only likely to offer a remedy as a last resort where there have been serious lapses in HMRC governance, rather than something to be deployed as standard. That's reinforced by the comment in the most recent version of the LSS that 'decisions on judicial review only need to be referred to the [Tax Disputes Resolution Board] where HMRC is considering not defending the judicial review'".

More or less European?

While for a long time the application of the EU fundamental freedoms in tax cases have been regarded as helping large businesses achieve flexibility in where they (genuinely) establish different parts of their operations, two leading Supreme Court decisions in 2017 suggest a shift more towards tax authorities. In the *Investment Trust Company* decision ([2017] UKSC 29), which flowed from a series of cases relating to the nature of supplies made by investment managers (*Claverhouse* (Case C-363/05)) and the validity or otherwise of statutory time limits (*Fleming* [2008] UKHL 2), the Supreme Court upheld HMRC's appeal in finding that investment companies which had been wrongly charged VAT by their managers were not entitled to recover from HMRC the full amount paid to the managers (but merely the net amount actually paid by the managers to HMRC after deduction of input tax by the managers). In *Littlewoods* [2017] UKSC 70, the Supreme Court effectively confirmed that a statutory remedy (e.g. to simple interest on overpaid VAT in this case) was an adequate remedy under EU law. Both decisions were welcomed by HMRC and have been presented as effective at barring common law claims that seek to address essentially the same issue as that dealt with in statute (even where such a claim may have a longer time limit or give rise to compound rather than simple interest). That, coupled with the potential limits on references to the CJEU post-Brexit, suggests EU rights will play a reduced role in UK tax disputes (and group litigation based around infringements of such rights will decline).

The caveat to that comes in two words: State aid. Both as a lightning rod for further investigations and another example of the goal posts appearing

to move, the focus in 2017 on whether tax rulings or legislative exemptions complied with European State aid rules continues to produce uncertainty and cost for businesses. Challenges by the European Commission to specific tax rulings or arrangements are not a new feature of the tax disputes landscape. While many in the US may think that they are the primary targets of the EU State aid challenges – and certainly that's the line taken in some corporate communication teams – this is not true (UK and other groups have already been affected) and developments in 2017 make it even clearer that the Commission's remit is broader than just US groups. Not only are there the ongoing in-depth investigations into European groups, including GDF Suez, and the reviews announced by the Dutch fisc in to several thousand tax rulings may prompt more, but the Commission has opened a State aid investigation into the group finance exemption (GFE) from the UK's controlled foreign companies rules.

The headline basis for the Commission's investigation is that the GFE gives 'some companies a better tax treatment than others'. The GFE is, of course, available to all taxpayers, but the test is whether it could lead to a difference in treatment between undertakings that are in a comparable legal and factual situation. A recent CJEU decision in *World Duty Free* (Case C-20/15) held that a Spanish tax exemption for investment in non-Spanish subsidiaries was State aid even though it was generally available; in practice, it was selective because it was available only to businesses investing overseas rather than in Spain. Even if the GFE is found to be selective on a similar basis, taxpayers with finance companies carrying on genuine activities in EEA countries will fall back on the *Cadbury Schweppes* case law (Case C196/04) as a defence to paying more tax. Further, the broad approach to selectivity implied in the Commission's approach to the GFE does not necessarily read across to other rulings or arrangements which could be (and are) genuinely used by all taxpayers. Europe is therefore set to remain an important front for many tax disputes.

Evidential challenges

The fact-heavy nature of many DPT and transfer pricing enquiries and the long look-back period for possible State aid issues, especially where both can involve detailed questions of economic substance, risk control and value contribution, means evidence has proved as key to resolving tax disputes in 2017 as technical arguments. Three points in particular stand out.

First, there can be real challenges in practice gathering the required information, which often includes substantial volumes of contemporaneous documents and emails. Taxpayers will continue to have to work with HMRC to ensure information requests are realistic in light of the data available, the timeframe of the investigation and other obligations on the taxpayer. One specific example of this last concern is data privacy, given the impending arrival of the General Data Protection Regulation (Regulation (EU) 2016/679), which introduces penalties based on worldwide turnover, and the real risks to data controllers of claims for mishandling personal data following the recent *Morrisons* judgment ([2017] EWHC 3113), which found Morrisons vicariously liable for the acts of a rogue employee explicitly seeking to harm Morrisons itself.

Second, HMRC's robust approach to 'the fundamental human right' that is legal privilege (contrast the LSS with *ex p Morgan Grenfell* [2002] UKHL 21 and *Three Rivers No. 6* [2004] UKHL 48), including direct challenges to taxpayers' claims to privilege, means care must be taken throughout an enquiry both to avoid waiving privilege in existing material and to ensure advice on sensitive issues to the core internal team or more senior stakeholders remains privileged.

Third, while the factual details will be essential in court or discussions with HMRC, taxpayers must have regard to the broader narrative or reputational impact of evidence that's unearthed or, in litigation, potentially disclosed publicly. That's particularly the case when considering

disclosures in accounts or results and possible market announcement obligations. These factors all mean that taxpayers have drawn upon not only technical tax specialists but the broader set of legal and corporate communications tools essential in other large scale investigations and disputes.

Conclusions

The points above all draw on direct tax issues for large business. Many of the same challenges arise for individuals, perhaps even more so given the way high net worth individuals can be viewed with suspicion publicly and at times by HMRC, even when the issues in dispute relate neither to offshore assets nor mass marketed arrangements. Practical challenges around record keeping and providing evidence to satisfy HMRC's governance process can be even more acute than for large businesses. Nonetheless, given the sums at stake and a political environment that prioritises a tough line on tax 'fairness' over encouraging business investment, tax disputes look set to remain firmly on large organisations' agendas for 2018. That prognosis is consistent with the additional £155m of compliance funding given to HMRC in the recent Budget, which is targeted to raise £2.3bn of additional revenue, and the introduction in September 2017 of the new failure to prevent the facilitation of tax evasion offence. Applying the lessons from 2017, taxpayers will need to commit litigation-scale resources sooner than before to obtain a 'good' outcome from any particular tax dispute.

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