Tax and the City Review

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HMRC publishes a revised hybrid capital instruments technical note, which includes new commentary on takeover and change of control clauses. The EU Commission publishes its full decision on the UK's CFC finance company exemption. The FTT decision in *Oxford Instruments* serves as a useful reminder of the limitation of tax rulings and that not all motive tests work in the same way. HMRC responds to stakeholders' concerns about the profit diversion compliance facility.

Hybrid capital instruments technical note

FA 2019 repealed and replaced the regulatory capital securities regime from 1 January 2019 with a new hybrid capital instrument (HCI) regime. 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 has updated its technical note (first published at Budget 2018) about the HCI regime to add a new paragraph 2.4 dealing with takeover and change of control clauses.

A concern had been raised that the standard term in convertible AT1 and RT1 notes to deal with takeovers - essentially providing for the notes to become write-down notes unless the acquiring parent entity enters into arrangements with the issuer providing for a conversion into the acquiring parent's shares instead - could cause notes to fall outside the HCI definition. This was because the standard term constituted a provision for conversion into the equity of someone other than a quoted parent (either because the acquiring entity acquired more than 50% of the issuer, triggering the takeover clause, but less than 75% such that it was not a "parent" or because the acquiring entity failed to meet the definition of being quoted).

New paragraph 2.4 states that certain instruments "do not meet the current definition" of HCI as a result, but that the government will use its power to fix this retrospectively with effect from 1 January, 2019 (when the new regime came into effect) by regulations. Whilst it is clearly welcome that HMRC is seeking to ensure the regime operates as intended and ab initio, it is questionable whether this change is really necessary. For the relevant notes to be convertible into shares in the acquiring entity, a change of control needs to have occurred and the acquiring entity needs to have signed up to an arrangement with the issuer providing for such conversion. Can it really be said that the notes contain a provision for that to happen from issue? There is a risk that taking such an overly wide view of when an instrument contains a provision for something will do more harm than good.

Commission releases full decision in UK CFC rules State aid case

The Commission's full decision was published on 25 April explaining why it considers that the UK's CFC finance company exemption (FCE) rules were partially non-compliant with State aid rules before the changes made with effect from 1 January 2019. The Commission accepted that applying full or partial exemption to profits which only passed through the CFC gateway because they were derived from UK capital contributions was a justified derogation from the reference system and hence not State aid. In essence, it was a proportionate measure to avoid the burden of tracing funding. However, applying an exemption to profits which were attributable to UK significant people functions (SPFs) was not a justified derogation. The Commission drew heavily on HMRC's own guidance to show that identifying SPFs, and allocating profits to them, did not carry the same level of difficulty as tracing funds.

The clock is now ticking for the UK to notify the Commission how it intends to go about recovering any aid (two months from notification) and to recover the aid (four months from notification), obligations the UK has irrespective of any appeal. All eyes will be on the UK government to see whether it makes an appeal – it would be unusual for a member state not to appeal a state aid decision against it – and what approach it intends to take to recovery in the interim. When the UK announced it was disapplying the FCE for profits attributable to UK SPFs with effect from 1 January, 2019 in order to ensure compliance with ATAD, it said it expected the impact on the Exchequer to be "negligible". One might, therefore, infer the aid granted and to be recovered should be equally "negligible", but this remains to be seen.

Aficionados of _Cadbury-Schweppes_ (Case C-196/04) will be interested to see the line that the Commission has taken on freedom of establishment. In particular, the Commission notes that "it is not a mistake" that the "escape clause" in the ATAD CFC rule (essentially disapplying the rule where the CFC carries on a substantive economic activity supported by staff, equipment, assets and premises) only applies to the passive income limb and not the SPF limb of the rule (or "non-genuine arrangements" in ATAD speak). The inference the Commission draws is that the EU legislature did not include an escape clause in the second limb because levying a CFC charge by reference to SPFs does not constitute a restriction on freedom of establishment.

Oxford Instruments: unallowable purpose

Oxford Instruments UK 2013 Limited v HMRC [2019] UKFTT 0254 (TC) raises a number of interesting points.

This case concerned the UK corporation tax treatment of a quasi-tower structure which had been set up in 2013 to refinance a US sub-group. Before settling on the tower structure, a number of tax efficient re-financing options were considered, including the use of a financing subsidiary with the benefit of the UK's CFC partial exemption. The tower structure was then unwound in September 2014 and replaced with a CFC structure, once it became clear that the impact of the BEPS project would likely lead to OI UK losing its tax deduction.

Tower structures were a common way for UK groups to finance their US operations. Generally, they involved a UK parent lending to its US subsidiary which, in turn, lent money to its UK subsidiary, to finance the acquisition of the group's US operations (a UK>US>UK>US tower, hence the name). The UK subsidiary was disregarded for US tax purposes such that the US recognised an interest deduction on the loan from the UK parent without pickup on the onloan whilst the UK was (prima facie) tax flat with interest income in the UK parent and interest expense in the UK subsidiary. As hybrid structures, groups tended to go for clearance on them under the UK's arbitrage rules (pre-dating the hybrid mismatch regime). And clearances were generally given either where the group could demonstrate equity funding in the UK or accepted a 25% disallowance (c.f. the full and partial finance company exemption rules).

OI's structure was a bit different because the offsetting deduction was generated not by a UK subsidiary borrowing to acquire US operations but by a newly formed UK resident subsidiary, OI UK, issuing a $140m promissory note to its US resident parent and subscribing for preference shares in that same US parent without any cash moving, as the distinct and final step in an eight step plan. OI UK applied for clearance for the tower structure under the anti-arbitrage rules. OI UK voluntarily disallowed 25% of the interest deduction arising on the payments of interest so that its tax position would be aligned with the 25% CFC tax pick up under the comparable CFC structure. (The FTT noted there was no statutory mechanic for such a voluntary disallowance where no arbitrage notice had been issued, the disallowance was effectively by concession). HMRC granted the anti-arbitrage clearance on this basis and included the statement that the clearance "did not provide clearance in respect of any other avoidance provision".

The case came before the First-tier Tribunal (FTT), however, because to OI UK's surprise, two years after the giving of the anti-arbitrage clearance, HMRC successfully challenged the interest deduction under CTA 2009 s441 on the basis that a main purpose of OI UK being a party to the promissory note was to secure a tax advantage.

On the one hand, this case can be seen as a very plain vanilla application of s441. Judge Beare had little difficulty concluding on the evidence that the sole purpose for OI UK borrowing under the promissory note was to generate the requisite UK tax deduction to offset the income generated by earlier steps. Particularly given the witness evidence to the effect that whilst steps 1 to 7 were required to achieve the group's US objectives, step 8 was not.

On the other hand, the taxpayer will no doubt feel rather miffed that HMRC even brought an unallowable purpose challenge under s441 CTA 2009 after granting an arbitrage clearance on motive grounds. Indeed Judge Beare added a postscript to his judgment noting that he had some sympathy with OI UK which was persuaded to enter into a structure it believed had the apparent blessing of HMRC. However, the judge was satisfied this was not a case of HMRC deliberately misleading the taxpayer at the time of the anti-arbitrage clearance. The s441 challenge arose later effectively as a result of a change of HMRC policy on tower structures.

It serves as a good reminder, then, that motive tests come in many different flavours and it is important always to identify whose purposes a particular test is examining, and in relation to what. So whilst the test in the arbitrage rules was whether a main purpose of the whole arrangement was obtaining a tax advantage for OI UK, the test under s441 was narrower: was a main purpose of OI UK being party to the promissory note to obtain a tax advantage? Somewhat ironically, this decision may help taxpayers in other s441 challenges where the borrower has a good purpose for its borrowing (to make a sound commercial investment, say) but HMRC think the wider arrangement has a tax advantage purpose and that is enough to bring s441 into play. As this decision shows, it is not. The tests are different.

It is also helpful that the case makes clear that, absent evidence to the effect that the directors are asleep at the wheel, a company's purposes are to be determined solely by references to the purposes of that company's directors and not the purposes of another group company, or its directors, or of any advisers to the company.

A potentially more unhelpful bit of the judgment comes, as is often the case, when the FTT decides to answer an unnecessary hypothetical question at the end of its judgment under the heading "Some final considerations" and in particular at paragraphs 122 and 123. Essentially the FTT asks itself whether the answer would have been different if, instead of finding that OI UK had been party to the promissory note for the sole purpose of obtaining a tax advantage, it had also had a commercial purpose. The FTT concludes, at paragraph 123, that s441 CTA 2009 would still have been in play. This conclusion is hardly surprising given that on that fact pattern OI UK was effectively assumed to have a tax advantage purpose and a commercial purpose. Of more interest is the statement that:

> "I would still have concluded that the note gave rise to a tax advantage in the form of the deductions in respect of the interest on the note"

The FTT appears to be treating the deduction as a tax advantage per se. Whilst that may be true on a literal construction of CTA 2010 s 1139(2)(a), most commentators would say, and HMRC generally accepts (see in particular paragraph C2.5 of the GAAR Guidance), that case law (in particular *IRC v Parker* [1966] AC 141 and *CIR v Tai Hing Cotton Mill* FACV No. 2 of 2007) has established that the existence of any advantage has to be judged by reference to the appropriate comparator transaction, being (in the words of HMRC's guidance) "the arrangements that would have occurred absent the abusive tax purpose (which may include no arrangement at all)".

It is no surprise then that the FTT concluded that the entire interest deduction was a tax advantage given its finding that, absent tax, step 8 would simply not have happened. However, in our view that should be on the basis not that an interest deduction is a tax advantage per se but, rather, that the appropriate comparator transaction to step 8 was "do nothing". And that if, hypothetically, OI UK had had a commercial purpose for issuing the promissory note as well as a tax purpose, whether or not the interest deduction constituted a tax advantage should be determined by first ascertaining what arrangement OI UK would have entered into to achieve that commercial purpose, had it not been thinking about tax, and then comparing the two.

Profit diversion compliance facility update

HMRC has written to stakeholders addressing feedback on their reaction to the Profit Diversion Compliance Facility (PDCF). HMRC is keen to emphasise that registration to use the PDCF will not be viewed by HMRC as an admission that tax returns are wrong and there will be further tax to pay. HMRC see the use of the PDCF as a two-stage process. At stage one, the business does some initial risk assessment and if it recognises there is a potential tax risk to consider it should register and arrange a meeting with HMRC to discuss the potential risk and plans for investigating it. At this stage, HMRC assures stakeholders that it will not assume that further tax will be due. A number of firms have asked HMRC if there could be "pre-registration" meetings to help the business decide whether to register but this is not in keeping with how the PDCF operates. It is for the business to decide whether or not to register in the light of its perception of the potential tax risks.

The second stage is for the business to review the risks and facts and present its emerging conclusions to HMRC at a pre-submission meeting. At this meeting, HMRC will highlight for discussion any significant concerns, giving the business the opportunity to take these into account before submitting the report. HMRC will judge all reports and proposals on their merits. A business may conclude that there is no further tax to pay and HMRC may agree or disagree.

HMRC is keen to explain its approach and commitment to the PDCF to the decision makers in foreign-owned multinationals. To this end, HMRC is looking to participate in events in key foreign jurisdictions to pass on HMRC's message and answer questions about the facility.

What to look out for:

- Between 13 and 15 May, the Upper Tribunal will begin the hearing of the appeal by the Irish Nationwide Building Society and another on whether the attribution of notional capital to a UK PE of an Irish bank is incompatible with the UK/Ireland double tax treaty.
- Between 20 and 22 May, the Upper Tribunal will hear HMRC's appeal in *Sippchoice Limited* on whether the definition of "relievable pension contributions" is wide enough to include non-cash payments ("in specie" contributions).
- On 27 May, the consultation closes on protecting taxes in insolvency.

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