

## **Chapter X: Tax arbitrage**

### ***Overview***

1. This Chapter rewrites sections 24 to 28, 30 and 31 of, and Schedule 3 to, F(No.2)A 2005, which were enacted to counteract avoidance involving tax arbitrage (“the tax arbitrage provisions”).

2. Different jurisdictions have different tax regimes, and different tax regimes often treat the same transaction in different ways. Multinational groups can arrange their affairs to take advantage of such discrepancies: this practice is called “tax arbitrage”. In tax arbitrage, the multinational group benefits at the expense of one or more of the fiscs.

3. The provisions in this Chapter have to be specifically activated by a notice from HMRC.

4. In general, the tax arbitrage provisions apply where an arbitrage scheme using a hybrid entity or instrument results in:

- a double deduction for the same expense, or a UK deduction for the payer in circumstances where the recipient is not taxed on the receipt (because, for example, a tax credit has eliminated liability to tax); or
- amounts being received by a company in a way that would not otherwise be taxable in the UK.

5. The hybrid entity or instrument will usually have been used deliberately to achieve one of these results.

6. The tax arbitrage provisions deal separately with deduction cases and receipts cases.

7. HMRC’s published guidance on the tax arbitrage provisions is currently available at <http://www.hmrc.gov.uk/international/arbitage.htm>.

8. The draft clauses in this Chapter are laid out in the following order.

- Clause 1 introduces the Chapter.
- Clauses 2 to 5 are about deduction notices.
- Clauses 6 to 12 are about the kinds of schemes which may be counteracted by deduction notices.
- Clauses 13 to 18 are about the consequences of deduction notices.

- Clauses 19 to 24 are about receipt notices.
- Clauses 25 to 27 make general provision about deduction notices and receipt notices.
- Clauses 28 and 29 are interpretative.

**Q1. We welcome comments on the structure of the Chapter.**

9. The opportunity has been taken to sharpen the drafting of these provisions. Long sentences have been broken up. Defined terms have been dropped where they are not needed. Lettered conditions have been introduced.

**Clause 1: Overview**

10. This clause introduces the Chapter and summarises its structure. It is new.

**Clause 2: Deduction notices**

11. This clause says when an officer of Revenue and Customs may give a company a deduction notice. It is based on section 24(1) and (2) of F(No.2)A 2005.

12. Briefly, the officer may give a company a deduction notice if the officer considers, on reasonable grounds, that the “deduction scheme conditions” are or may be met in relation to a transaction to which the company is party.

13. Section 24(1) of F(No.2)A 2005 gives this function to the Commissioners for Her Majesty’s Revenue and Customs. In practice, the Commissioners delegate this function to officers of Revenue and Customs, and *subsection (1)* reflects this. This is a minor change in the law: see *Change 601* in Annex 1. The Commissioners delegate the function of giving deduction notices to a group of specialist officers; Change 601 will make no change to this practice.

14. Section 703 of ICTA (transactions in securities) gave the function of giving counteraction notices to the Board. Rewriting this for income tax purposes, Chapter 1 of Part 13 of ITA gave this function to officers of Revenue and Customs, and the proposal in Bill 6 is to make the same change in the law in rewriting section 703 of ICTA for corporation tax purposes (see CC/SC (07) 28). The proposal to make Change 601 in clause 2 is consistent with this approach.

15. Because Change 601 is made in clause 2, it is also made in clauses 5, 25 and 26.

**Q2. We welcome comments on the proposal in clauses 2, 5, 25 and 26 to give officers of Revenue and Customs the function of giving deduction notices (Change 601).**

16. Section 24(2) of F(No.2)A 2005 provides that the company has to be within the charge to corporation tax. This condition is rewritten more succinctly in subsection (1).

17. *Subsection (2)* defines the expressions “deduction notice” and “the deduction scheme conditions”.

18. *Subsection (3)* signposts the consequences of a deduction notice.

**Clause 3: The deduction scheme conditions**

19. This clause specifies the “deduction scheme conditions”. It is based on section 24(3) to (6) of, and paragraph 1 of Schedule 3 to, F(No.2)A 2005.

20. The source legislation labels these conditions “conditions A to D”. These labels have been retained.

**Clause 4: Meaning of schemes achieving UK tax advantage for a company**

21. This clause defines when a scheme achieves a UK tax advantage for a company. It is based on section 30(2) to (4) of F(No.2)A 2005.

22. Section 231 of ICTA is also being rewritten in this Bill. The reference to it in *subsection (2)(a)* will be updated in due course.

**Clause 5: Further provisions about deduction notices**

23. This clause makes further provisions about deduction notices. It is based on section 24(7) and (8) of F(No.2)A 2005.

24. Under *subsections (2) and (3)*, deduction notices are given by officers of Revenue and Customs. This is a minor change in the law (Change 601): see the commentary on clause 2 and Annex 1.

**Clause 6: Schemes involving hybrid entities**

25. This clause is the first of a group of seven clauses defining types of “deduction scheme” (see condition A in clause 3(2)). It is based on paragraphs 2 and 3 of Schedule 3 to F(No.2)A 2005.

26. ITTOIA and ITA only used Schedules for consequentials, savings, transitionals, repeals and indexes, and this practice is being followed in Bills 5 and 6. Accordingly, Schedule 3 to F(No.2)A 2005 is being rewritten in the body of the clauses on tax arbitrage. If further statutory definitions of “deduction scheme” need to be added to the list, new sections can be inserted at the end of the present group.

**Clause 7: Instruments of alterable character**

27. This clause is the second in a group of seven clauses defining types of “deduction scheme”. It is based on paragraphs 4 and 5 of Schedule 3 to F(No.2)A 2005.

**Clause 8: Shares subject to conversion**

28. This clause is the third in a group of seven clauses defining types of “deduction scheme”. It is based on paragraphs 4 and 6 of Schedule 3 to F(No.2)A 2005.

29. Paragraph 6(1)(a) and (b) of Schedule 3 to F(No.2)A 2005 define a scheme, in two alternative ways, by reference to “shares subject to conversion”. This two-part definition is rewritten in *subsection (1)*.

30. Paragraph 6(2) of Schedule 3 to F(No.2)A 2005 defines “shares subject to conversion”, using the expression “the relevant time”. This definition is rewritten in *subsections (2) to (4)*.

31. Paragraph 6(3) of Schedule 3 to F(No.2)A 2005 defines “the relevant time” for the purposes of paragraph 6(2) of that Schedule.

32. The definition of “the relevant time” in paragraph 6(3)(a) of Schedule 3 to F(No.2)A 2005 only applies to cases within paragraph 6(1)(a) of that Schedule, and the definition of “the relevant time” in paragraph 6(3)(b) of that Schedule only applies to cases within paragraph 6(1)(b) of that Schedule. However, the source legislation does not make this distinction immediately obvious. Accordingly, *subsections (5) and (6)* rewrite paragraph 6(3)(a) and (b) as two separate propositions applying, respectively, for the purposes of the two alternative cases in *subsection (1)*.

**Clause 9: Securities subject to conversion**

33. This clause is the fourth in a group of seven clauses defining types of “deduction scheme”. It is based on paragraphs 4 and 7 of Schedule 3 to F(No.2)A 2005.

34. This clause and its predecessor are very similar, but it is considered that attempting to merge them would be likely to create confusion.

35. *Subsections (5) and (6)* rewrite paragraph 7(3)(a) and (b) of Schedule 3 to F(No.2)A 2005 as two separate propositions. See the commentary in clause 8 on the rewrite of paragraph 6(3) of that Schedule.

**Clause 10: Debt instruments treated as equity**

36. This clause is the fifth in a group of seven clauses defining types of “deduction scheme”. It is based on paragraphs 4 and 8 of Schedule 3 to F(No.2)A 2005.

**Clause 11: Scheme including issue of shares not conferring qualifying beneficial entitlement**

37. This clause is the sixth in a group of seven clauses defining types of “deduction scheme”. It is based on paragraphs 9 and 10 of Schedule 3 to F(No.2)A 2005.

38. Paragraph 12 of Schedule 3 to F(No.2)A 2005 provides that being “connected” with a person for the purposes of paragraph 10 of that Schedule is determined by section 839 of ICTA (connected persons). Section 839 of ICTA will be rewritten in this Bill, and this Bill will include a provision to the effect that the clause rewriting section 839 of ICTA will apply for the purposes of this Bill unless otherwise indicated. This provision will apply in particular to “connected person” in *subsection (1)(a)*. Paragraph 12 of Schedule 3 to F(No.2)A 2005 is therefore not being rewritten as a separate proposition.

39. The group relief provisions are being rewritten in this Bill (see CC/SC (07) 27). The references to the group relief provisions in *subsection (6)* are being kept under review; they will be updated as necessary.

#### **Clause 12: Scheme including transfer of rights under a security**

40. This clause is the last in a group of seven clauses defining types of “deduction scheme”. It is based on paragraph 11 of Schedule 3 to F(No.2)A 2005.

41. As explained in the commentary on clause 11, this Bill will include a provision to the effect that the clause rewriting section 839 of ICTA (connected persons) will apply for the purposes of this Bill unless otherwise indicated. This provision will apply in particular to “connected” in *subsections (4) and (6)*. This Bill will therefore not rewrite as a separate proposition paragraph 12 of Schedule 3 to F(No.2)A 2005, which applies section 839 of ICTA for the purposes of paragraph 11 of that Schedule.

42. Paragraph 11(6)(a) of Schedule 3 to F(No.2)A 2005 is rewritten in the Chapter-wide definition of “security” in clause 29. (See the note on that definition in the commentary on that clause.) Paragraph 11(6)(b) of that Schedule is rewritten in *subsection (8)*, to which the Chapter-wide definition of “security” in clause 29 is subject.

#### **Clause 13: Consequences of deduction notices**

43. This clause sets out the consequences of a deduction notice being given. It is based on section 25(1), (2) and (14) to (16) of F(No.2)A 2005.

44. *Subsection (1)* says when this clause applies.

45. *Subsection (2)* obliges the company to calculate (or recalculate) its income or chargeable gains for the purposes of corporation tax or its liability to corporation tax.

46. *Subsection (3)* stipulates that the calculation (or recalculation) must be done in accordance with the rule against double deduction (clause 14) and, if appropriate, the rule against deduction for untaxable payments (clause 18).

47. If the company considers that the deduction scheme conditions are in fact not met in relation to the transaction specified in the deduction notice, the company can

make (or decide not to amend) its company tax return on the basis that the deduction notice is invalid. It is then up to HMRC to open an enquiry into the return if it considers the notice still to be valid.

48. If, however, the company concedes that the deduction notice is valid, it can adjust its company tax return. *Subsection (4)* provides that (so far as the scheme specified in the deduction notice is concerned) the company is treated as having complied with subsections (2) and (3) if it incorporates “the necessary relevant adjustments” in its company tax return for the accounting period specified in the notice.

49. *Subsection (5)* defines when adjustments are “relevant”.

50. *Subsection (6)* defines when relevant adjustments are “necessary”.

#### **Clause 14: The rule against double deduction**

51. This clause spells out the rule against double deduction referred to in clause 13(3)(a). It is based on section 25(3) to (5) and (17) of F(No.2)A 2005.

52. To the extent to which an amount in relation to an expense is “otherwise deductible or allowable”, *subsection (1)* restricts the amount allowable as a deduction.

53. *Subsection (2)* defines “otherwise deductible or allowable”, by reference to the purposes of any tax to which this subsection applies.

54. *Subsection (3)* provides that subsection (2) applies to any tax (including any “non-UK tax”), with two exceptions. The two exceptions relate to oil taxation because, in that area, the UK tax system envisages relief being obtained for the same amount twice.

55. Subsection (3) refers to section 501A of ICTA. Section 501A will also be rewritten in Bill 6, and the reference to it will be updated in due course.

56. *Subsection (4)* extends the scope of subsection (2) to cover amounts for which relief (a) is not available but (b) would be available but for a “tax rule” that has the same effect as the rule in subsection (1).

57. The definition of “tax rule” is given in *subsection (5)*.

58. *Subsection (6)* defines “non-UK tax” by reference to clause j4808Drm of this Bill, which is based on section 403D of ICTA (group relief). See clause 87 in CC/SC (07) 27 (group relief).

#### **Clause 15: Application of the rule against deduction for untaxable payments**

59. This clause lays down the conditions for the rule against deduction for untaxable payments to apply. It is based on section 25(6) and (17) of F(No.2)A 2005.

60. Under *subsection (1)*, the rule applies if three conditions are all met. These conditions are spelt out in *subsections (2) to (4)*.

61. In section 25(6)(c) of F(No.2)A 2005, the phrase “as a result of provision made or imposed by the scheme” qualifies “is not liable to tax” as well as “his liability to tax is reduced”. But it does so by implication rather than explicitly. Subsection (4) makes this implication explicit.

62. *Subsection (5)(b)* defines “non-UK tax” by reference to clause j4808Drm of this Bill, which is based on section 403D of ICTA (group relief). See clause 87 in CC/SC (07) 27 (group relief).

**Clause 16: Cases where payee not treated as not liable as a result of scheme**

63. This clause makes further provision about condition C in clause 15. It is based on section 25(8) to (10) of F(No.2)A 2005.

64. *Subsection (1)* clarifies the exception (in section 25(8) of F(No.2)A 2005) to one of the conditions which may cause the tax arbitrage legislation to apply. This is a minor change in the law, in the taxpayer’s favour: see *Change 646* in Annex 1.

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| <p><b>Q3. We welcome comments on the proposal to clarify section 25(8) of F(No.2)A 2005 (Change 646).</b></p> |
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**Clause 17: Cases where payee treated as having reduced liability as a result of scheme**

65. This clause makes further provision about condition C in clause 15. It is based on section 25(7) of F(No.2)A 2005.

**Clause 18: The rule against deduction for untaxable payments**

66. This clause spells out the rule against deduction for untaxable payments laid down in clause 13. It is based on section 25(11) to (13) of F(No.2)A 2005.

67. *Subsection (1)* states that the rule is that “the total deduction amount” must be reduced.

68. *Subsection (2)* defines “the total deduction amount”.

69. If the payee is not liable to tax at all in respect of the payment or payments under review, *subsection (3)* reduces the total deduction amount to nil.

70. *Subsections (4) and (5)* deal with the case in which the payee is liable to tax in respect of part, but not all, of the payment or payments under review.

### **Clause 19: Receipt notices**

71. This clause says when an officer of Revenue and Customs may give a company a receipt notice. It is based on section 26(1) and (12) of F(No.2)A 2005.

72. Briefly, the officer may give a UK resident company a receipt notice if the officer considers, on reasonable grounds, that the “receipt scheme conditions” are or may be met in relation to the company.

73. Section 26(1) of F(No.2)A 2005 gives this function to the Commissioners for Her Majesty’s Revenue and Commissioners. In practice, the Commissioners delegate this function to officers of Revenue and Customs, and *subsections (1) and (2)* reflect this. This is a minor change in the law: see *Change 601* in Annex 1. The Commissioners delegate the function of giving deduction notices to a group of specialist officers; Change 601 will make no change to this practice.

74. Section 703 of ICTA (transactions in securities) gave the function of giving counteraction notices to the Board; rewriting this for income tax purposes, Chapter 1 of Part 13 of ITA gave this function to officers of Revenue and Customs, and the proposal in Bill 6 is to make the same change in the law in rewriting section 703 of ICTA for corporation tax purposes (see CC/SC (07) 28). The proposal to make Change 601 in clause 19 is consistent with this approach.

75. Because Change 601 is made in clause 19, it is also made in clauses 22, 25 and 26.

**Q4. We welcome comments on the proposal in clauses 19, 22, 25 and 26 to give officers of Revenue and Customs the function of giving receipt notices (Change 601).**

76. *Subsection (3)* defines a “receipt notice” and “the receipt scheme conditions”.

### **Clause 20: The receipt scheme conditions**

77. This clause specifies the “receipt scheme conditions”. It is based on sections 26 and 27 of F(No.2)A 2005.

78. Section 26(2) of F(No.2)A 2005 uses the twofold expression “makes or imposes provision”. This expression appears to have been borrowed from the basic rule on transfer pricing in paragraph 1(1) of Schedule 28AA to ICTA, which is also being rewritten in this Bill. In due course, a decision will be taken on whether the twofold expression needs to be used in *subsection (2)*. Meanwhile, no particular comment is sought on it.

79. Section 26(5) of F(No.2)A 2005 uses the expression “tax purposes”, and by virtue of section 832(3) of ICTA “tax” in that context means “income tax or corporation tax”. Elsewhere in the present Chapter, however, “tax purposes” is used

with a different meaning. Therefore, to prevent possible confusion, *subsection (6)* expands “tax purposes” to “income tax purposes or corporation tax purposes”.

80. Section 26(4) of F(No.2)A 2005 provides: “Condition C is that, as regards the qualifying payment made by the paying party, there is an amount that ... may be deducted or otherwise allowed *in respect of the payment* under the law of any territory outside the United Kingdom.” The definition of “deductible amount” in *subsection (7)* omits as otiose the italicised words.

**Clause 21: Amounts within corporation tax**

81. This clause supplements clause 20(3) and (5). It is based on section 26(8), (9), (10) and (14) of F(No.2)A 2005.

82. In section 26(9)(a) of F(No.2)A 2005, “income or gains” must mean “income or chargeable gains”, because a reference to “gains” which were income in nature would be superfluous. *Subsection (2)(a)* makes this implication explicit.

83. Section 26(9)(a) of F(No.2)A 2005 refers to “the accounting period in which the qualifying payment was made *in relation to the company*”. *Subsection (2)(a)* omits as otiose the italicised words.

84. Section 26(10) of F(No.2)A 2005 refers to the loan relationships legislation, which is being rewritten in Bill 5. The references to the loan relationships legislation in *subsection (4)* will be updated in due course.

**Clause 22: Further provisions about receipt notices**

85. This clause makes further provisions about receipt notices. It is based on section 26(12) of F(No.2)A 2005.

86. Under *subsection (1)*, receipt notices are given by officers of Revenue and Customs. This is a minor change in the law (*Change 601*): see the commentary on clause 19 and Annex 1.

**Clause 23: Exception for dealers**

87. This clause provides an exception for some dealers who would otherwise meet condition D of the receipt scheme conditions. It is based on section 26(6) and (7) of F(No.2)A 2005.

88. *Subsection (2)* refers to section 95 of ICTA (taxation of dealers in respect of distributions etc). Section 95 of ICTA is being rewritten in Bill 5; the reference to it will be updated in due course.

**Clause 24: Rule for calculation or recalculation of income etc following receipt notice**

89. This clause gives the rule for calculating or recalculating income, chargeable gains or liability to corporation tax following a receipt notice. It is based on section 27 of F(No.2)A 2005.

**Clause 25: Notices given before tax return made**

90. This clause meshes the tax arbitrage legislation in with the machinery of Company Tax Self Assessment in cases in which a deduction notice or a receipt notice is given before the company's company tax return is made for the accounting period specified in the notice. It is based on section 28(1), (2) and (11) of F(No.2)A 2005.

91. Under *subsection (1)*, deduction notices and receipt notices are given by officers of Revenue and Customs. This is a minor change in the law: see the commentary on clauses 2 and 19 about Change 601 and Annex 1.

**Clause 26: Notices given after tax return made**

92. This clause meshes the tax arbitrage legislation in with the machinery of Company Tax Self Assessment in cases in which a deduction notice or a receipt notice is given after the company's company tax return has been made for the accounting period specified in the notice. It is based on section 28(3) to (7) and (12) of F(No.2)A 2005.

93. Under *subsections (1), (2) and (6)*, deduction notices and receipt notices are given by officers of Revenue and Customs. This is a minor change in the law: see the commentary on clauses 2 and 19 about Change 601.

94. Section 28(7) of F(No.2)A 2005 refers to the company being requested "to produce or provide information". It is, however, not possible for a company to provide information without producing it. Subsection (6)(a) therefore omits "produce or" as superfluous.

**Clause 27: Amendments, closure notices and discovery assessments where section 26 applies**

95. This clause concerns amendments to company tax returns, closure notices and discovery assessments in cases in which clause 26 applies. It is based on section 28(8) to (11) of F(No.2)A 2005.

**Clause 28: Meaning of references to schemes and series of transactions**

96. This clause is interpretative. It is based on section 30(1) of F(No.2)A 2005.

**Clause 29: Minor definitions**

97. This clause is interpretative. It is based on sections 25(18) and 28(12) of, and paragraphs 6, 7 and 11 of Schedule 3 to, F(No.2)A 2005.

98. For the purposes of paragraph 6 of Schedule 3 to F(No.2)A 2005, “security” has the same meaning as in Part 6 of ICTA. Section 254(1) of that Act defines “security” for the purposes of that Part of that Act. Section 254(1) of that Act is being rewritten in clause j52543(1) of this Bill, to which this clause accordingly refers. The cross-reference will be kept under review as work on the Bill progresses.

#### **Schedule 2: Transitionals and savings etc**

99. Saving provisions arising from the rewrite of the tax arbitrage provisions will be published as part of the draft Bill 6. Meanwhile, the opportunity has been taken to note that a saving provision will preserve the effect of section 31(4) and (5) of F(No.2)A 2005.

#### **Annex 1**

##### **Change 601: References to “officer of Revenue and Customs”: clauses 2, 5, 19, 22, 25 and 26**

This change replaces references to the “Commissioners for Her Majesty’s Revenue and Customs” in the source legislation with references to “an officer of Revenue and Customs”.

[The Change note will also discuss the replacement of “Board of Inland Revenue” with “an officer of Revenue and Customs”. This discussion is omitted here.]

The provisions affected by this change will in future authorise or require things to be done by or in relation to an officer of Revenue and Customs rather than by or in relation to the Commissioners. This reflects the way in which Her Majesty’s Revenue and Customs is organised and operates in practice. Section 13 of the Commissioners for Revenue and Customs Act 2005 allows nearly all functions conferred on the Commissioners to be exercised by any officer. All of the functions affected by this change, which are in the main concerned with administrative processes, are in fact exercised by officers of the Commissioners, and the Commissioners themselves are not personally involved in their exercise.

Each provision affected by the conversion of references to the Commissioners will be identified in the Table of Origins by a cross-reference to this change.

***This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.***

##### **Change 646: avoidance: tax arbitrage: cases where payee not treated as not liable as a result of scheme: clause 16**

This change clarifies the exception (in section 25(8) of F(No.2)A 2005) to one of the conditions which may cause the tax arbitrage legislation to apply.

Chapter 4 of Part 2 of F(No.2)A 2005 addresses avoidance involving tax arbitrage. If the statutory conditions are met in a deduction case, the company in question must calculate (or recalculate) its income and chargeable gains for the purpose of

corporation tax, or its liability to corporation tax, in accordance with rule A in section 25(3) of that Act and rule B in section 25(6) of that Act. Under section 25(6)(c) of that Act, one of the conditions for rule B to apply is that:

“in respect of the payment or payments that the payee receives or is entitled to receive as a result of the transaction or series of transactions [mentioned in section 25(6)(a) of that Act], or part of such payment or payments, the payee is not liable to tax or, if liable, his liability to tax is reduced as a result of provision made or imposed by the scheme [mentioned in section 25(6)(a) of that Act].”

Section 25(8) of F(No.2)A 2005 makes an exception to section 25(6)(c) of that Act. It provides:

“The requirement in subsection (6)(c) is not satisfied if the payee is not liable to tax because he is not liable to tax on any income or gains received by him or for his benefit under the tax law of any territory.”

It is arguable that section 25(8) of F(No.2)A 2005 leaves it open for section 25(6)(c) of that Act to be satisfied if:

- the payee is in principle liable to tax in respect of the payment or payments; but
- this liability is extinguished by some form of tax relief which is not connected with the scheme.

But in practice HMRC do not interpret section 25(8) of F(No.2)A 2005 so narrowly. Clause 16(1) of this Bill therefore expressly excludes this narrow interpretation.

***This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with generally accepted practice.***