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Tax and the City Review

The OECD's consultation on the proposed regulated financial services exclusion from the new taxing right for market jurisdictions known as Amount A of pillar one provides an insight into how the exclusion will apply. The OECD's report for the G7 on strengthening international tax administration includes high level recommendations for common and co-ordinated collaborative rules. The FTT in *Hexagon* considers the loan relationships related transaction rule in the context of a debt release where the bank waived part of the debt as compensation for mis-selling. HMRC consults on including cryptoassets within the investment management exemption.

New taxing right: regulated financial services exclusion

Although concerns remain about how and when 'Amount A' of pillar one of international tax reform might be implemented, in particular by the US, the OECD continues to consult on the individual building blocks of the new rules. The consultation on the proposed regulated financial services (RFS) exclusion which closed on 20 May gives an insight into how the exclusion will apply. Amount A introduces a new taxing right for market jurisdictions over the residual profits of the largest and most profitable enterprises.

The starting point is that the revenues and profits of regulated financial institutions (RFIs) will be excluded from Amount A, although it has not yet been agreed if this exclusion should cover reinsurance and asset management. The effect of the RFS exclusion is to treat the in-scope part of any group as a standalone business from the RFS part so that the revenues and profits of in-scope entities can be isolated. Getting to this stage is not straightforward, however, and depending on the characteristics of the group, there are different options for combining the in-scope entities into one consolidated bespoke group.

There will be seven types of RFI, each of which is separately defined, and apart from the category of 'RFI Service Entity', each of these definitions is broadly made up of three elements: a licensing requirement, a regulatory requirement and an activities requirement. Group treasury centres and captive insurers whose business consists to a substantial extent in the provision of services to non-RFI group members are explicitly excluded from falling within any of the RFI categories. On the other hand, group members providing administrative services to an associated RFI can fall within the exclusion as an 'RFI Service Entity' if they exclusively perform functions for an RFI that are necessary to the carrying out of activities of the RFI.

The original ambitious timeline envisaged the multilateral instrument to implement Amount A being signed by mid-2022 but the OECD has now acknowledged this will not be possible and implementation will be delayed a year to 2024 onwards. The OECD now hopes to reach technical agreement on pillar one at the G20 meeting in November.

Tax co-operation for the 21st century: OECD report for G7

There have been many changes to the international tax landscape over the last ten years, and more to come with the two-pillar reforms so now would seem a good time to consider strengthening and co-ordinating the tax administration framework. The OECD has written a report for the G7 on strengthening international tax co-operation which includes a number of recommendations. The report highlights the need for simple, collaborative and digital administration of common rules and looks at how timeliness could be improved with real-time data availability and incorporating compliance by design.

The recommendations for the corporate tax administration of the future include ensuring the framework for international tax co-operation enhances rather than obstructs cross-border investment, introducing common rules for a collaborative approach with early and binding resolution, and removing burdens by eliminating duplicative measures addressing essentially similar risks. These are ambitious objectives and, if achieved, would improve certainty and deliver other benefits for business and for tax authorities.

The OECD notes that the report is intended to provide a high-level vision to stimulate discussion and that further work would be required to translate them into action 'which may involve changes to domestic rules and procedures as well as relevant international tax rules'. The OECD stands ready help do this work, but having seen how complex the pillars one and two proposals are working out to be and the amount of effort involved, any co-ordinated changes to international tax administration are likely going to take some time to agree and implement.

Hexagon: damages for mis-selling and the scope of the loan relationship rules

The taxpayer in Hexagon Properties Limited v HMRC [2022] UKFTT 00137 (TC) had reached a settlement agreement with its bank in respect of a claim for damages for a mis-sold interest rate hedging product. The taxpayer had owed the bank around £5m so rather than the bank making a payment to the taxpayer of the agreed amount of damages, under the terms of the settlement the bank accepted a payment of approximately £1.5m and waived the other £3.5m.

The taxpayer recognised a credit of £3.5m in its accounts which HMRC argued was taxable as a trading receipt under the loan relationships rules as a profit from a related transaction. The taxpayer argued the sum was damages which represented wholly, or in part, a receipt of capital outside the scope of the loan relationships charge to corporation tax and claimed to be entitled to the benefit of ESC D33 in respect of the capital element.

The preliminary issue for the FTT to decide was whether the £3.5m was taxable in its entirety under the loan relationship rules. The FTT found that the extinguishment of £3.5m of the debt fell within the definition of 'related transaction' for the purpose of CTA 2009 s304 and that any profit arising to the taxpayer from the related transaction must be brought into account as a loan relationship. HMRC argued (based on *Union Castle* [2020] EWCA Civ 547) that once the accounts recognised a credit in respect of the relevant related transaction, the amount necessarily constituted a profit to be brought into account under the loan relationship rules. But the FTT dismissed that argument finding that the £3.5m arose from the claim in damages against the bank and did not 'arise from' any related transaction of its loan relationships. This was reinforced by the note in the undisputedly GAAP-compliant accounts identifying it as a receipt of compensation for the mis-sold hedging product.

As the taxpayer won on the preliminary issue, further evidence and argument is now required in order to address the characterisation of the damages payment as income or capital in nature under general taxation principles.

Given the FTT's description of this as the bank "effectively paying £3.5 million by way of damages" to settle the taxpayer's claims, it is perhaps not surprising that it concluded that the tax treatment should be the same as if that is what the settlement agreement had provided for (whether by gross payment flows or set-off). But one might reasonably say that instead of paying the taxpayer £3.5 million by way of damages, the bank allowed the taxpayer to make a £3.5 million profit on its debt in order to compensate it instead. It is certainly not as clear to us as it was to the FTT that the profit did not arise from the release of the debt. Indeed, it feels a bit like the distinction between motive and purpose. What was the purpose of the man in shooting his wife? To kill her. Why did he shoot his wife? Jealous rage. What was the purpose of the bank in releasing the debt? To give the taxpayer a profit. Why? To settle the taxpayer's compensation claims.

And what of the bank? Presumably if the FTT had had to consider the other side of the transaction it would say the bank's (we assume) corresponding debit was similarly not a loss arising from a related transaction in relation to the loan relationship? Or if the parties were connected, that the £3.5 million was still potentially taxable outside the loan relationship rules notwithstanding the exclusion of release credits on connected company loan relationships and the exclusivity of the loan relationships regime? It will be interesting to see what the Upper Tribunal makes of all of this if HMRC appeal.

Investment management exemption: consultation on including cryptoassets

As part of establishing clear UK tax and regulatory treatment of cryptoassets to promote innovation in cryptoasset and blockchain technologies, HMRC is consulting until 18 July on the scope of a proposed extension to the investment transactions list (ITL) used for the investment manager exemption (IME). A summary of responses together with draft legislation will be published in Autumn 2022.

Where the conditions are satisfied, the IME enables non-UK resident investors to appoint UK-based investment managers to conduct certain investment transactions on their behalf without bringing them into the scope of UK taxation. The UK based investment managers, on the other hand, are subject to tax on their investment management fees. The IME is a key factor in the UK's attraction for management of non-resident funds and bringing in UK tax on fees.

Only specified types of transactions qualify for the IME and these are listed on the ITL which is kept under review as the investment management industry evolves. The ITL identifies transactions that form part of investment business and would not generally be viewed as trading activities, to provide certainty that those types of transactions will not be taxed as trading activity in the UK.

The consultation asks which types of cryptoassets should be included within the IME and whether the change should also apply to the other tax regimes which use the ITL (such as diversely owned authorised investment funds, exempt unauthorised unit trusts, diversely owned reporting offshore funds and approved investment trusts).

The definition of cryptoassets will be crucial to the ITL working properly and HMRC intends to include only assets which utilise cryptography and distributed ledger technology. The consultation notes that the definition should be clear and user-friendly and be 'future-proof' by being capable of encompassing newly emerging crypto technologies. HMRC is considering a definition of cryptoasset similar to that proposed by the OECD in March 2022: 'The term 'Cryptoasset' refers to a digital representation of value that relies on a cryptographically secured distributed ledger or a similar technology to validate and secure transactions.' HMRC would then refine this definition to exclude certain categories of assets currently excluded from the ITL, for example, transactions in land and cryptoassets which provide for the transfer of assets not already included in the ITL.

What to look out for:

- At the 17 June ECOFIN meeting, France is expected to make a final attempt to secure unanimity on the directive to implement the global minimum tax before the end of the French Presidency. It is unlikely that Poland will drop its opposition, however, without a legally binding mechanism to ensure pillar one will also be implemented.

- Between 22-24 June the Upper Tribunal is scheduled to commence the hearing of the appeal in HMRC v Pickles on whether amounts left outstanding on directors' loan accounts are taxable as distributions for CTA 2010 s1020.

- The Upper Tribunal is scheduled to commence the hearing in HMRC v Aozora GMAC Investment Ltd between 12-14 July on whether ICTA 1988 s793A(3) applies to deny unilateral relief for US withholding tax on interest paid to a UK resident that was not a qualified person within the limitation on benefits article of UK/US DTT.

- HMRC is consulting until 30 June on draft regulations to extend beyond 1 January 2023 the exemption for certain hybrid regulatory capital instruments issued by banks. The EU Anti-Tax Avoidance Directive previously imposed restrictions, including a sunset clause, on the exemption.

- Draft legislation for inclusion in Finance Bill 2023 will be published on "L Day" which is expected in July (based on last year's timing).

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