TAX AND THE ENERGY SECTOR

The discussion of the meaning of 'incidental' by the Court of Appeal in *Dolphin Drilling* may be of interest in other contexts such as for determining whether something is a main purpose under the loan relationship unallowable purpose rule. The summary of responses to the consultation on the modernisation of transfer pricing, diverted profits tax and permanent establishments confirms a number of proposed changes (including incorporating the DPT regime as part of corporation tax) and highlights changes still under consideration. HMRC publishes the latest statistics on transfer pricing and DPT which include that DPT has secured more than £8.5 billion of revenue from when DPT was first introduced to the end of the 2022-23 tax year. The latest OECD statistics show that ICAP is working effectively for MNEs and tax administrations with 20 cases completed by October 2023 and more in progress.

Dolphin Drilling: meaning of 'incidental'

The Court of Appeal in *HMRC v Dolphin Drilling Ltd* [2024] EWCA Civ 1 allowed HMRC's appeal concluding that the provision of accommodation for offshore workers was a significant and independent end in itself and not (as the First-tier Tribunal (FTT) and Upper Tribunal (UT) had held) 'incidental' to the other uses of the chartered vessel. Although the facts of this case are quite niche (concerning the hire cap under the oil contractor regime in CTA 2010 Part 8ZA), it will be interesting to see if the discussion of the meaning of 'incidental' will be picked up in other tax contexts, including in the application of the purpose test in a double tax treaty, or whether a purpose is a 'main purpose' under the CTA 2009, section 441 unallowable purpose test in the loan relationship rules.

The FTT in *Dolphin Drilling* had approached the issue by giving 'incidental' its ordinary meaning, then noting that something is 'incidental to another matter if it is subordinate, or secondary, to it'. A use could be 'incidental' notwithstanding that it was important if, viewed in context, it was 'secondary to (or less important than)' another use or uses. The FTT had held the provision of accommodation was 'incidental' in that sense. The Court of Appeal, however, held the UT was wrong not to allow HMRC's appeal. Whilst they agreed that 'incidental' had to be given its ordinary meaning, they noted that the approach the FTT had taken of seeking to define the ordinary meaning by reference to other words (subordinate, secondary) risked losing nuance and meaning and that a better way to determine the ordinary meaning of a word was by reference to illustrative examples of how it was used in everyday contexts.

David Ewart KC, acting for HMRC, argued that for a use, A, to be incidental to another use, B, there must be some link between them. He gave the example of a barrister using a laptop to write a shopping list (use A) when it is primarily used to write legal opinions (use B). Using the laptop to write a shopping list might be of lesser importance than writing legal opinions, but it is not incidental to it because it is an independent unconnected end. The Court of Appeal agreed. The real meaning of 'incidental' was not in some way lesser, as the FTT had found (and the UT had failed to overturn), but rather that use A is incidental to use B if it arises out of use B or as a by-product of it.

Given the number of 'main purpose' cases rumbling through the system at the moment, it will be interesting to see whether this line of thinking is picked up in any of them. The UT will shortly hear the appeal in *Burlington Loan Management* [2022] UKFTT 290 (TC) on the purpose test in the interest article of the UK/Ireland treaty and during the course of this year the Court of Appeal is scheduled to hear appeals in all three of *BlackRock LLC 5* [2022] UKUT 199 (TCC), *Kwik-Fit* [2022] UKUT 314 (TCC) and *JTI Acquisition Company* [2023] UKUT 194 (TCC) on the unallowable purpose test in the loan relationship rules.

For example, in *Burlington* the FTT said the question that it had found hardest to address was whether SICL, a Cayman company which owned a receivable on which it would suffer UK withholding tax, had, in assigning the receivable to an Irish resident company which would be entitled to gross payment under the UK/Ireland double tax treaty unless the main purpose test applied, a main purpose of taking advantage of the relevant treaty provision because it got a higher purchase price as a result. The FTT held not, on the basis that SICL's sole purpose was to achieve the best price for its receivable. But applying the Court of Appeal's reasoning from *Dolphin Drilling*, might one argue that even if SICL also had a purpose of benefiting from the interest article under the UK/Ireland

treaty, that purpose could only ever be 'incidental' to its purpose of selling its receivable to the highest bidder, in the sense of being a by-product of it, and that any purpose which is incidental to another purpose should not really be qualified as 'main'?

One could also imagine the 'by-product' test being useful in certain loan relationship unallowable purpose cases. If the facts show a sufficient commercial driver for the transaction, could any tax deductions arising as a result, and any purpose of achieving them, necessarily fall to be treated as incidental and not main because they are merely a by-product? Or, conversely, where the facts show that obtaining tax deductions was the real driver for the transaction, could any commercial purpose be treated as merely a by-product in the same way? That would have certain echoes of Judge Beare's (obiter) comments in *Oxford Instruments* [2019] UKFTT 254 that the taxpayer's purpose of obtaining a spread was 'just a means to secure the tax advantage purpose and not a self-standing purpose in its own right'. I.e. the purpose of obtaining a spread was merely a by-product of the purpose of securing the tax advantage.

Of course, there may well be situations where there are multiple purposes and none of them is a by-product of any other, as was the case with the multiple uses in *Dolphin Drilling* itself. But there must certainly be an argument based on *Dolphin Drilling* that if a purpose can be shown to be a by-product of another purpose it must necessarily be incidental to it and should therefore not be treated as a main purpose.

Modernisation of transfer pricing/diverted profits tax/permanent establishment: summary of responses

HMRC's summary of responses on the consultation on proposed reform to transfer pricing, permanent establishment (PE) and diverted profits tax (DPT) shows which proposals are being taken forward, which ones are not, and which require further consideration. All three areas are concerned with ensuring the appropriate amount of profit is taxed within the UK, and HMRC recognises there is a balancing act between the compliance burden on taxpayers and the need to protect the UK tax base. At the heart of the proposed reforms is the desire to increase inward investment into the UK. HMRC has engaged extensively with stakeholders and will continue to do so with a technical consultation on draft legislation later this year.

Transfer pricing

Changes are proposed to make the transfer pricing rules simpler, more certain and better aligned with tax treaties. One such change is the amendment of the participation condition to make it more targeted to address known problem cases. Additional guidance will be provided in some areas, such as on the 'one-way street' and on any legislative changes made to UK:UK transfer pricing. Guidance will also be issued on the application of the new rule replacing ss 152-154 TIOPA with a fixed rule which disregards the effect of guarantees (but not implicit support) on the amount of the debt where the provision of the guarantee is within the scope of transfer pricing. This guidance would also set out the government's view on the impact of implicit support.

PEs

It has been decided that the domestic legislation on PE attribution will be aligned with Article 7 of the 2017 OECD Model Tax Convention (MTC) and that this will be supported by the Commentary and OECD Report on the Attribution of Profits to PEs. There will be a technical consultation on the draft legislation to achieve this and on improving guidance on how to apply the OECD commentary and report to domestic attribution cases to mitigate uncertainty.

HMRC has confirmed that regardless of whether changes are made to align the UK domestic definition of PE with the MTC definition (which is still under consideration), the investment manager exemption (IME) and the Independent Broker Exemption will be retained but the government will consider if changes are needed to clarify the operation of these exemptions.

Concerns have been raised about the proposal to adopt the definition of PE in Article 5 OECD MTC. Expanding the definition of a dependent agent PE to align with Article 5(5) OECD MTC would lower the threshold for a PE and would give rise to additional PEs across various sectors including insurance, financial services and asset management. The asset management sector raised a number of concerns about the impact of the reforms and the uncertainty they would introduce which may lead to some investment activities currently carried on in the UK moving offshore. In particular, UK investment managers often have ability and authority to negotiate contracts and change contracts in respect of the non-UK funds they manage, and this would create a dependent agent PE of the funds managed in cases where the IME conditions are not satisfied or where the ongoing monitoring for the IME exemption is too much of a compliance burden. These concerns have been noted and discussions are ongoing with the asset management sector to ensure changes to the PE definition do not have unintended consequences for foreign investors in funds managed or advised upon in the UK. The government response states that a sub-adviser treated as agent for the purposes of the PE rules will also be treated as such by the IME.

DPT

DPT was introduced as a standalone tax in 2015 but it is to be merged into the corporation tax regime whilst maintaining the key (deterrent) features of the regime. Whilst this is intended to bring welcome simplification, many respondents questioned whether there is still a need for DPT, especially in the light of the Pillar 2 rules and improvements in the OECD's transfer pricing guidelines following the OECD's Base Erosion and Profit Shifting work. The government commits to keeping the regime under review and considering the impact of the evolving landscape but for now deems it necessary to retain it to protect the UK tax base.

There will be a technical consultation on the administration of the reformed DPT, on how a DPT assessment will interact with MAP and on draft legislation. Further guidance is being considered in certain areas, such as around the safe harbour conditions.

Transfer pricing and diverted profits tax statistics 2022-2023

The latest statistics published 25 January show a continued decline in the number of advance pricing agreements (APAs) agreed per year. In 2022-2023 it was just 15 with an average time of nearly 4 years to reach agreement. Perhaps suitable candidates are now turning to ICAP (see below) for practical certainty in a shorter timeframe rather than the lengthy process of APAs followed by the mutual agreement procedure (MAP) to get legal certainty. The number of MAP cases resolved in 2022-2023 (131) was the same as for the previous year although the average time to resolve cases increased by 7 months to 28 months.

The Profit Diversion Compliance Facility (PDCF) continues to work well for HMRC: two-thirds of the large businesses targeted decided to use the facility to bring their tax affairs up to date quickly and efficiently. Although there were only two PDCF letters issued by HMRC last year while HMRC resources were focused on the progression and conclusion of cases already in the PDCF (24 cases were resolved in 2022-23), further targeted letters have been issued during 2023 to 2024. HMRC is investigating the multinationals that received PDCF letters and chose not to register and the small number which registered but had their final proposals rejected.

DPT has secured more than £8.5 billion of revenue from when DPT was first introduced in 2015-16 to the end of the 2022-23 tax year. DPT has helped HMRC to settle over 200 investigations for additional corporation tax and HMRC is currently involved in about 90 reviews into multinationals with arrangements to divert profits (including those who have registered under the PDCF). The tax under consideration in these cases was £2.6 billion at the end of March 2023.

OECD ICAP: latest statistics

The latest OECD statistics on the International Compliance Assurance Programme (ICAP) shows it to be working effectively with 20 cases completed by October 2023 and more in progress. ICAP is a voluntary programme for multilateral cooperative risk assessment and assurance. It provides increased and earlier tax certainty for MNE groups and gives tax authorities assurance that any tax risks have been identified. The voluntary process is available to large MNE groups headquartered in the jurisdiction of one of the participating tax administrations. The UK has been involved since the first pilot in 2018 together with Australia, Canada, Italy, Japan, the Netherlands, Spain, and the US. As of October 2023 there were 22 participating jurisdictions and more are in discussion about joining. There are two annual application deadlines for MNEs to apply for ICAP in their headquarter jurisdiction: 31 March and 30 September.

The ICAP process enables participating MNE groups to meet the relevant tax administrations to talk through their country-by-country reports (CBCR) and other documentation and provide clarity to aid understanding of their cross-border activities. This helps tax administrations to reach an early decision about the level of core risks, and other specific international tax risks, if any, presented by the data contained in the CBCR and which the relevant tax authorities agree to include. There are five core risk areas covered by the programme: tangible goods, intangibles, services, financing and PEs. Financing and intangible assets have had the highest proportion of not low-risk outcomes but still 75% of tax administrations provided low-risk outcomes in these areas. The number of tax administrations involved in a risk assessment ranged from 3 to 9, with the average being 5. In 32% of cases, issue resolution was applied to one or more of the risk assessment issues.

The timeline for ICAP will depend upon a number of factors, but in most cases the target period from the initial meeting of the taxpayer and tax authorities to the issuance of assurance letters is within 12 months although the recent statistics show average timeframes were above the ICAP targets due to a number of factors, including the Covid-19 pandemic.

What to look out for:

- On 14 February, the Upper Tribunal is scheduled to hear the appeal in Silverdoor limited v HMRC [2022] UKFTT 233 (TC) on whether the VAT financial services exemption applies to the card handling fees.
- Between 19 and 23 February, the Upper Tribunal is scheduled to hear the appeal in *Burlington Loan Management DAC v HMRC* [2022] UKFTT 290 (TC) on the purpose test in the interest article in the UK/Ireland double tax treaty. The FTT had ruled that the assignment to an Irish resident company of a debt owed by a UK company to a Cayman lender did not have a main purpose of taking advantage of the interest article in the UK/Ireland double tax treaty.
- 28 February is the closing date for the consultation on amendments to the Mutual Societies (Transfers of Business) (Tax) Regulations 2009. The proposed changes will update the current rules for transfers of business by building societies to reflect changes made in 2017 to transfers of trade and the use of losses. This includes greater flexibility for

the offset of post-1 April 2017 trade losses, subject to some restrictions in the first 5 years after the transfer of business. It is proposed that the amendments apply retrospectively to transfers of business by building societies occurring from 1 January 2023.

- On 5 march the Court of Appeal is scheduled to hear the appeal in *BlackRock Holdco 5 LLC v HMRC* on transfer pricing and the loan relationship unallowable purpose rule. This is the first of a trio of unallowable purpose cases to be heard by the court of appeal this year; the others are *Kwik-fit* (to be heard in April) and *JTI Acquisition Company* (scheduled for hearing in May).

- The first of this year's fiscal events, the Spring Budget, will be delivered by the Chancellor on 6 March.

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