

Taxes — Not So Certain After All? HMRC Looks to Mind the Gap

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The size of the UK's 'legal interpretation tax gap' is a matter of increasing concern to the government, so much so that it has now published its second consultation on the topic. A 'legal interpretation tax gap' arises where a tax authority (in the UK, Her Majesty's Revenue and Customs (HMRC)) and a taxpayer take a different view of the meaning of the tax law as it applies in a particular case. In the UK the gap between the amount that HMRC would expect to collect based on its interpretation of tax law and the amount of tax that is actually collected in these uncertain situations is estimated to be £4.9 billion, and this figure is only likely to increase unless active measures are introduced to reduce it.

To this end, the government proposes to introduce a system that requires large businesses to notify HMRC of uncertain tax treatments as described in its second consultation document. The proposed notification regime aims to encourage large businesses to engage with HMRC from the outset on areas of legal interpretation uncertainty. The USA and Australia already have systems like this in place, so the government may be looking to these jurisdictions for inspiration.

Definition of Uncertain Tax Treatment

An uncertain tax treatment is where there is more than one way to interpret or apply tax legislation in relation to a transaction. The proposal will require a business to tell HMRC where:

- they have used an interpretation or application of tax law for a transaction that is contrary to HMRC's known position; or
- they are dealing with a new or novel type of product, transaction or business structure where there are various ways that it can be treated under existing legislation and HMRC's position is not known.

This measure will apply only to large businesses, meaning only those businesses with an annual turnover above £200 million or a balance sheet total over £2 billion will be affected by the proposal.

A key concern is that there needs to be an objective way to assess whether a tax treatment is uncertain. Defining uncertain tax treatment as being one that HMRC may challenge or is likely to challenge, as suggested in the previous consultation, was considered to be too subjective. Therefore, the government has proposed seven triggers to assess tax treatments in a more objective and predictable way. These triggers are listed below.

1. Results from an interpretation that is different from HMRC's known position

This trigger is intended to require notification where a business adopts a tax treatment that relies on a different interpretation of the law from HMRC's known position. This would capture interpretations that are inconsistent with HMRC's guidance or other material in the public domain, for example, HMRC's tax manuals, or HMRC's view as established in previous dealings between the business and HMRC.

2. Was arrived at other than in accordance with known and established industry practice

Some industries have an established industry-wide approach to treating certain transactions. This is often published in HMRC manuals or guidance. A notification would be required where a business adopts an approach that is not consistent with the industry-wide approach.

3. **Is treated in a different way from the way in which an equivalent transaction was treated in a previous return, and the difference is not the result of a change in legislation, case law or a change in approach to accord with HMRC's known position**

This trigger would cover situations where a business alters a previously used tax treatment, where that change is not due to a change in HMRC's known position – it is likely to overlap with the first trigger.

4. **Is in some way novel such that it cannot reasonably be regarded as certain**

A notification would be required where there is a new or novel product, transaction or business structure where there are various ways that it can be treated and HMRC's position is not known.

5. **In respect of which a provision has been recognised in the accounts of the company or partnership, in accordance with generally accepted accounting practice (GAAP), to reflect the probability that a different tax treatment will be applied to the transaction.**

This trigger includes situations where IFRIC23 (or other accounting standard) requires the business to make a provision to recognise the uncertainty in the tax treatment. For example, a business encountered a transaction in a niche area. It applied a tax treatment which it believed was correct, but following discussion with the company's auditors, it took the view that a tax provision should be recognised in the accounts to reflect the likelihood of a different tax treatment being applied.

6. **Results in either:**

- **a deduction for tax purposes greater than the amount incurred by the business; or**
- **income received for which an equivalent amount is not reflected for tax purposes, Unless HMRC is known to accept this treatment**

This trigger requires a business to notify HMRC when the economic outcome is not the same as the tax outcome and that difference is not an intended consequence of the relevant tax legislation. Occasionally, there are situations when a deduction is intended to exceed the economic cost, for example in research and development expenditure.

7. **Has been the subject of professional advice, which is not protected by legal professional privilege:**

- **which is contradictory, in terms of tax treatment, to other professional advice they have received; or**
- **which they have not followed for the purpose of determining the correct tax treatment of a given transaction**

HMRC state in the consultation that this trigger will apply to accountancy or tax advice; however, it would seem that where the tax advice relates to lawyer-client advice in a legal context, then legal professional privilege should be available. For example, a large business instructs their agent to undertake a hybrids analysis. The agent produces a report which identifies one particular group entity which may be seen as a hybrid, but it would depend on whether HMRC viewed the entity as transparent or opaque. HMRC's position is unclear, but the agent advises their client to file on the basis that the entity is caught by the hybrids legislation at Part 6A of Taxation (International and Other Provisions) Act 2010. The large business considers the advice, but does not follow it. Therefore, a notification would be required.

Notification of Uncertain Tax Treatment

The uncertain tax treatment should only be notified if it results in a difference of £5 million between the business' calculations of their tax liability and HMRC's expected calculation of their tax liability. This should help to identify issues where businesses have adopted different interpretations to HMRC and reduce the legal interpretation tax gap. The government proposes a two-step process to calculate whether this £5 million threshold is exceeded and notification is required:

1. Is the total tax impact of the tax treatment £5 million or above? The total tax impact includes both deductions taken against taxable income and the non-inclusion of receipts for tax purposes where those treatments would be considered 'uncertain' under the proposed triggers.
2. If the tax difference between the business' treatment and HMRC's expected treatment is more than £5 million tax threshold, then a notification is required. Where a tax calculation results in a range, rather than a specific number, then the calculation resulting in the largest difference should be used as the basis to determine whether a notification is owed.

Notifications will be an annual process and a separate notification will be required for each of the relevant taxes.

The government has proposed a group notification option for value-added tax (VAT), which would exclude tax neutral inter-entity transactions. A group notification option could also apply to direct taxes.

The government intends to publish, as guidance, a list of information that should be included in the notification. It has proposed that the notification should include the following information:

- a concise description of the transaction;
- nature of uncertainty;
- periods affected by the uncertainty;
- an indication of the amount of tax relating to the uncertainty; and
- date of the transaction/event giving rise to uncertainty.

Respondents to the first consultation raised concerns that the proposed scope of the notification regime was too broad and should be limited to corporation tax which would be comparable with the USA and Australian models. HMRC has now proposed that the relevant taxes under the regime will be corporation tax, VAT and income tax (including employment taxes).

Exceptions

Anything that is disclosable under a different legislation requirement will not need to be notified. If HMRC are already aware of the uncertainty, and how the business plans to treat it for tax purposes, the business will not be required to bring it to HMRC's attention again through the notification process, unless the business treats the transaction contrary to HMRC's recommendation.

Penalties for Failure to Report

The government has proposed to charge a penalty on the large business to which the failure to notify relates. A penalty will not be charged on individuals, except where the failure relates to a partnership and the uncertainty is in relation to the partnership return. The penalty will be £5,000. This will be appealable and there will be a reasonable excuse provision.

The second consultation on the notification of uncertain tax treatment by large businesses closes on 1 June 2021.

CONTACTS

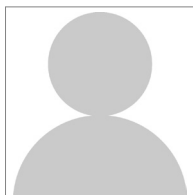
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