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REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

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HM Revenue & Customs

Settling large tax disputes

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HM Revenue & Customs

Settling large tax disputes

Report by the Comptroller and Auditor General

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Audit Departments Act 1921.

Amyas Morse
Comptroller and Auditor General
National Audit Office

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This report examines the reasonableness of five large tax settlements and the Department's processes for reaching the settlements.

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Contents

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This report can be found on the National Audit Office website at www.nao.org.uk/large-tax-disputes-2012

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Summary

Introduction

1 Section 2 of the Exchequer and Audit Departments Act 1921 requires the Comptroller and Auditor General (C&AG) to examine the accounts of HM Revenue & Customs (the Department) to ascertain that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and allocation of revenue, and that they are being duly carried out.

2 In July 2011, the Comptroller and Auditor General (C&AG) published his report (the C&AG's Report)[1] on HM Revenue & Customs 2010-11 Accounts. The C&AG's Report concluded that the Department's governance processes for resolving tax disputes were sound and that these were followed in a substantial majority of the 27 cases examined. However, in four of the largest settlements, the Department decided to use alternative governance arrangements. In three of these four cases, there was no, or limited, separation between negotiating and approving the settlements. This reduces the demonstrable assurance that these settlements were appropriate. The C&AG's Report also noted two cases where the Department overlooked key stages in its established governance processes.

3 The Committee of Public Accounts (the Committee) held hearings on the C&AG's Report on 12 and 17 October and 7 November 2011. Its report on these hearings made clear that the Committee had serious concerns about how the Department handled the settlements where it bypassed or overlooked governance arrangements until it was too late.[2] The Committee also concluded that the Department refused to disclose taxpayer information and that this made it impossible for Parliament to hold the Department to account. The Committee concluded that there was no absolute statutory bar on disclosing taxpayer information and that this was a policy decision by the Department's commissioners. It concluded that, in making this decision, the Department had not given proper regard to its duty to assist the Committee and asked the Department to set out in greater detail how it came to this decision. The Department takes the view that to disclose taxpayers' confidential information in evidence to a Parliamentary Committee would be unlawful because it would hinder rather than help the Department's function of collecting tax.

1 Comptroller and Auditor General, *HM Revenue & Customs Annual Report and Accounts 2010-11*, Session 2010–2012, HC 981, 7 July 2011.

2 HC Committee of Public Accounts, *HM Revenue & Customs 2010-11 Accounts: tax disputes*, Sixty-first Report of Session 2010–12, HC 1531, 20 December 2011.

4 The Department recognises the need for increased accountability and is proposing to strengthen its internal governance arrangements. The Department intends that these new governance arrangements will be sufficient to assure the Committee that the settlements it reaches are appropriate. There should not be a need for external reviews of settlements, such as this one, to provide this assurance. The NAO will have a role in providing assurance that the Department's arrangements are operating effectively, and will continue to have access to the detail of individual settlements.

5 There has been significant press coverage of the concerns expressed by whistle-blowers in some of these cases. Whistle-blowers have also directly contacted the C&AG and the Committee. In undertaking this work, we have been aware of the issues raised by whistle-blowers, and have examined the basis of these concerns.

6 To address the lack of assurance over the settlements where the Department set up alternative governance arrangements, or overlooked existing governance arrangements, we have examined five of these settlements. These five include the settlements where the Committee had particular concerns.[3] Sir Andrew Park, a retired tax judge, provided expert tax advice. For each of the five settlements, we asked Sir Andrew Park to consider whether:

- the settlement value was reasonable in view of the circumstances of the case;
- the settlement was consistent with the Department's *Litigation and Settlement Strategy*;[4]
- the Department obtained appropriate legal advice and acted upon the advice at all relevant stages; and
- the Department followed its own procedures.

7 In evaluating reasonableness, we have considered whether the settlements represent fair value for the Exchequer and were in the public interest. This included considering whether the settlement was as good as or better than the outcome that might be expected from litigation, considering the risks, uncertainties, costs and timescale of litigation.

3 In the C&AG's Report of July 2011, we found two settlements where the Department overlooked its existing governance arrangements. In one of the settlements, the error in process was relatively minor and did not have significant consequences. In the other settlement, the errors in process, and the consequences, were significant, so we included the settlement in the scope of this review.

4 HM Revenue & Customs, *Litigation and Settlement Strategy*, 2007, available at: http://www.hmrc.gov.uk/practitioners/lss.pdf

8 The C&AG is bound by Section 182 of the Finance Act 1989, which makes it an offence to disclose information about an identifiable taxpayer. The Act allows for lawful disclosure of such information for the purposes of the C&AG's functions. This report focuses on the reasonableness of individual tax settlements and the Department's actions in reaching these. Whilst it is necessary to give some of the details of the tax issues under consideration to show how we reached our conclusion on reasonableness, the identity of the taxpayer is not central to making these judgements, or to assessing the Department's processes for reaching settlements. The C&AG considers that it is not necessary to identify taxpayers to fully report on these issues. For this reason, we have not named taxpayers, and refer to them in this report as Companies A to E, respectively. Where possible, we have also omitted details of the settlements that would reveal the identity of the taxpayer. In some cases, certain details of the settlements are already in the public domain and we recognise that these taxpayers may be identifiable.

9 Sir Andrew Park reported the results of his examination of each settlement to the C&AG in detail. These reports contain extensive details about the disputed tax issues that are confidential to taxpayers. Sir Andrew Park's reports allowed the C&AG to make a full judgement on the reasonableness of the settlements and the Department's processes for reaching these, and we have set out these judgements and conclusions in this report. The C&AG considers that disclosing Sir Andrew Park's reports would breach taxpayer confidentiality.

Key findings

On reasonableness

10 All five settlements were reasonable, and at least one may have been better than reasonable. We found that all five settlements were reasonable ones for the Department to have reached in the circumstances. The concerns raised by whistle-blowers were often based on a partial understanding of the settlement because the details were confidential. In this context, the concerns made sense. The conclusions on reasonableness depend upon understanding of the settlement as a resolution of several issues, as well as the detail of the individual issues.

11 These large tax settlements are complex and there is no clear answer as to what represents the 'right' tax liability. The Department used its judgement to decide how the law applied to the complex facts and, in each case, there was a range of justifiable positions the Department might have taken. For example, three of the cases involved the Department challenging, and developing defensible alternative scenarios for, the companies' long-standing transfer pricing arrangements. Where the Department and the taxpayer disagree, they can either reach a compromise settlement that both sides can accept, or pursue the issues in litigation, which is likely to involve a long and very expensive process of appeals through the courts.[5]

5 This is explained in the C&AG's Report of July 2011, Figure 5 and paragraph 2.9.

12 The Department introduced senior decision-makers to help deliver settlements to an accelerated timescale, but it did not always ensure that the specialist staff involved in the cases understood the reasons for settlement. Some of the specialist staff working on some of the cases where the Department operated alternative governance arrangements were excluded from the final negotiations. These specialist staff had concerns about the appropriateness of the settlements reached, and did not feel that the Department adequately addressed these. While the settlements reached were reasonable, poor internal communication of the reasons for settlements has resulted in a loss of confidence in the settlements, internally and externally.

13 In settling these cases, the Department resolved multiple, long-outstanding tax issues. All of the cases involved multiple tax issues and covered multiple tax years. Some of the issues had been outstanding for well over a decade. In four of the cases, the Department successfully used an accelerated negotiation process to reach a settlement. The resolution of these issues is in line with the Department's commitment to reduce the number of long-running enquiries with large businesses. Given that the settlements reached were reasonable, the resolution of the issues is welcome.

The Department's processes for reaching the settlements

14 Although all five settlements were reasonable, this work confirmed our concerns about the processes by which the settlements were reached.

The compatibility of settlements with the *Department's Litigation and Settlement Strategy*

15 Four settlements were fully compatible with the *Litigation and Settlement Strategy*. It is less clear that the settlement with company D was compatible with the *Litigation and Settlement Strategy*. There are some issues where the possible outcomes are either that the taxpayer owes nothing or that it owes the full amount. In these circumstances, the *Litigation and Settlement Strategy* does not permit 'splitting the difference', that is settling for less than the full amount. The agreed settlement with company D was lower than the tax liability that would have been paid if the Department won in litigation. Given the uncertainties and costs of litigation, it was reasonable for the Department to settle at the amount it did. However, it is not clear that this is compatible with the *Litigation and Settlement Strategy*.

16 When negotiating the settlement with company E, the Department's staff believed that there was a barrier to charging interest on the employer's National Insurance contributions (NICs). There was no barrier to charging interest, and the Department did not check this before agreeing to settle without interest. The Department's decision not to charge interest was reasonable in the context of reaching a settlement on several issues, but the Department should have checked the position on interest so that it could have made an informed decision on this issue.

17 The definition of a package deal in the *Litigation and Settlement Strategy* requires each issue to be assigned a value. It does not prohibit settling the individual issues in a wider settlement on different terms than would be considered if the issue was settled by itself. The Department updated the *Litigation and Settlement Strategy* in 2011. The updated version addresses this point by adding that each disputed issue should be considered and resolved on its own merits. However, it does not recognise the reality that when the Department and a taxpayer enter a process to resolve multiple complex, finely-balanced issues at once, interdependency is created between these issues.

Obtaining and acting on legal advice.

18 The Department did not always need to seek legal advice before agreeing settlement terms. In one case, there was litigation ongoing but the Department did not consult its lawyers. In most cases, there was no need to seek legal advice during the settlement negotiations. The issues were not in litigation and the negotiations were about technical or accounting issues, with which the Department's other relevant specialists were best placed to deal. However, litigation was in progress on the employer's NICs issue when company E and the Department met and agreed a settlement. The Department did not obtain legal advice on the settlement terms for this issue before agreeing it with the taxpayer.

19 In negotiating the settlement with company C, the Department's Solicitor's Office gave legal advice orally, not in writing. Given the circumstances of the case, and the nature of the advice, the advice should have been confirmed in writing. This advice was on an issue where the Department's action was reasonable, but it was not easy to find a technical legal basis to underpin it. This review confirms our conclusion in paragraph 2.36 of the C&AG's Report in July 2011 that it would have been appropriate to have had the advice in writing.

Complying with governance processes

20 The findings from the review of these five settlements confirm our concerns over the governance arrangements operated in these cases. Although the settlements reached were reasonable, there was no clear justification for setting up alternative governance arrangements. All cases should have followed standard governance procedures, including being referred to the High Risk Corporates Programme Board. There should have been independent review of large settlements, and separation of roles in negotiating and approving settlements. We also confirmed that the Department did not always keep notes of key meetings, including meetings at which settlement terms were agreed in principle with taxpayers.

21 The Department has acknowledged that its governance arrangements needed strengthening. It is introducing new arrangements to provide greater transparency, scrutiny and accountability. The Department intends to appoint an assurance Commissioner, who will have to approve all settlement proposals over £100 million. The assurance Commissioner will have no role in individual taxpayer's affairs, so that their role as an independent check on settlements is not compromised. The assurance Commissioner will also review future settlements to check whether internal governance processes have been followed.

Overall conclusion

22 All five settlements were at least reasonable, and the overall outcome for the Exchequer was therefore good. There is a strong case for improving the processes for reaching these settlements, particularly separation of roles in negotiating and authorising settlements. It is not appropriate to set up specific governance arrangements, or to fail to apply processes correctly and there is a need for stronger assurance that the Department has applied its processes correctly. The Department has accepted this and is changing its governance arrangements. The *Litigation and Settlement Strategy* needs to better reflect the reality of settlements in complex cases where multiple issues are resolved.

Recommendations

23 The Department should update the *Litigation and Settlement Strategy*, or the guidance accompanying it, to make clear how cases involving controlled foreign companies are compatible with the *Litigation and Settlement Strategy*. The Department negotiated a settlement that was not clearly compatible with the *Litigation and Settlement Strategy*, despite the outcome being reasonable. It may be clear to the Department's staff how cases involving controlled foreign companies comply with the strategy, but external observers may misunderstand it. This could undermine confidence in the appropriateness of the settlements reached.

24 The Department should update the *Litigation and Settlement Strategy*, or the accompanying guidance, so that it sets out more clearly the extent to which it is acceptable to settle individual issues in the context of a wider settlement. The Department has updated the *Litigation and Settlement Strategy* so that it now requires each issue to be resolved on its own merits and not as part of a package deal, but it could do more to recognise the potential interdependency of issues in these circumstances.

25 The Department should ensure that lawyers are always consulted before finalising settlements on issues that are in litigation. The Department negotiated a settlement on an issue that was in litigation without consulting its lawyers.

26 The Department should explain more clearly to its specialist staff how settlements are reached, including, where appropriate, the rationale for the settlement terms on individual issues. Some of the Department's specialist staff working on settlements had concerns about the appropriateness of the settlements reached. The Department did not do enough to address these concerns satisfactorily. The Department's revised governance arrangements, particularly appointing an assurance Commissioner, should also help to restore confidence that the settlements reached are appropriate.

27 The Department should ensure that it makes clear to taxpayers that settlements agreed in principle should not be considered final until they have been through all relevant approval processes. The Department held a meeting with a taxpayer at which a settlement proposal was reached. It did not tell the taxpayer that the settlement depended on further governance processes, and effectively bound itself to settling on the terms discussed in that meeting.

Part One

Introduction

1.1 Tax disputes are a long-established feature of the UK's, and other countries', tax systems. Many businesses, especially the largest, trade globally and operate in multiple countries. Corporate structures and the nature of transactions reflect this, while new technologies and other developments mean that businesses may be operating in a climate of rapid change. These complexities, together with the possibility of quite different but defensible interpretations of complicated tax legislation, mean that establishing UK national tax liabilities in the context of a multinational group is often far from straightforward. The interpretation of case law and precedent can play a key role in resolving uncertainties over the interpretation of tax legislation. Companies will be motivated to organise their affairs to minimise their global tax liabilities and tax disputes arise where HM Revenue & Customs (the Department) and the taxpayer reach different views on the appropriate tax payable. It is therefore important that the Department has strong and transparent governance arrangements to oversee their process for reaching large tax settlements.

C&AG's Report on HMRC's 2010-11 Accounts

1.2 In July 2011, the Comptroller & Auditor General (C&AG) published his report (the C&AG's Report)[6] on HM Revenue & Customs 2010-11 Accounts. The Report examined the adequacy of the Department's governance processes for resolving tax disputes with large companies, and whether the Department had complied with these processes.

1.3 The C&AG's Report concluded that the Department's governance processes for resolving tax disputes were sound and that these were followed in a substantial majority of the 27 cases examined. However, in four of the largest settlements, the Department decided to use alternative governance arrangements.

1.4 In these four cases, the settlements were signed off by commissioners without referring them first to the High Risk Corporates Programme Board (the Programme Board), which usually considers large and contentious settlements. In three of these cases, one or both of the commissioners signing off the settlement had also participated in the settlement negotiations. This meant that there was no, or limited, separation in the role of negotiating and approving these three settlements. This reduced the demonstrable assurance that these settlements were appropriate.

6 Comptroller and Auditor General, *HM Revenue & Customs Annual Report and Accounts 2010-11*, Session 2010–2012, HC 981, 7 July 2011.

1.5 The C&AG's Report also noted two cases where the Department did not comply with its established approval procedures. In one of these cases, this lack of compliance had significant consequences. The Department negotiated a settlement with a company without making the company aware that the settlement was subject to approval by the Programme Board. When the settlement was subsequently considered by the Programme Board, it did not approve one of the settlement terms.

Committee of Public Accounts hearings and report

1.6 The Committee of Public Accounts (the Committee) held hearings on the C&AG's Report on 12 and 17 October and 7 November 2011. The Committee's subsequent report put on the record the Committee's serious concerns about how the Department handled the settlements where it bypassed or overlooked governance arrangements.[7]

1.7 The Committee's main recommendations for improving the processes for reaching tax settlements were as follows:

> "The Department must ensure that its revised procedures to separate out the roles of those involved in settling tax disputes are applied to all cases without exception.
>
> Appropriate rules need to be established which will ensure that all settlements over £100 million are assessed independently and that a random sample of those over £10 million are assessed independently each year. It is important that the new role [the independent assessor] is demonstrably independent and increases accountability to Parliament, and should be established in statute.
>
> Independent assessors should report annually to Parliament on their work, perhaps in a statement contained in the Department's annual report and accounts. This should include aggregate information on the cases in which they were involved and a report on any settlements where they have identified concerns.
>
> The Department must ensure that it has applied all relevant governance checks to each settlement before finalising them with taxpayers.
>
> It must also consult legal advisers before settling cases in litigation and make sure it keeps its own accurate and complete records of key meetings with companies."

1.8 In response, the Department has announced that it is changing its governance arrangements.[8] It intends to appoint a new assurance Commissioner who, together with two other commissioners, will review all cases with tax at stake over £100 million before they are settled. The assurance Commissioner will be an experienced tax professional, so that he or she has an informed view of the tax issues being settled. To ensure that there is separation between negotiation and sign off of settlements, the assurance Commissioner will not engage with taxpayers on their individual tax affairs.

7 HC Committee of Public Accounts, *HM Revenue & Customs 2010-11 Accounts: tax disputes*, Sixty-first Report of Session 2010-12, HC 1531, 20 December 2011.
8 Treasury Minute Cm 8305, Session 2010–12, 27 February 2012.

1.9 The Department is also introducing a programme of reviews of settled cases of all sizes to test whether the Department's policies and procedures are being followed consistently and to identify improvements. The Department's audit and risk committee will consider the findings of the review programme and recommend follow-up actions. The Department has said it will have all of these changes in place by the summer of 2012.

1.10 The Department intends that these governance arrangements will give the Committee assurance that the settlements the Department reaches are appropriate. There should not be a need for external reviews of settlements, such as this Report, to provide this assurance. The NAO will assess whether the Department's arrangements are operating effectively. We will also continue to have access to the detail of individual settlements, to provide this assurance and undertake our other work.

1.11 The Committee also concluded that:

> "The Department's refusal to disclose taxpayer information prevents proper scrutiny of the process for reaching tax settlements with large companies… The Department was not able to point to an absolute statutory bar on disclosure of information about specific cases. Its withholding of information is in fact a policy decision taken by commissioners. This approach fails to give proper regard to the Department's duty to assist the Public Accounts Committee in examining whether or not the Department is giving best value for money."[9]

1.12 The Department is bound by the confidentiality requirements set out in Sections 18 and 19 of the Commissioners for Revenue and Customs Act 2005. Section 18(2)(a) permits disclosure for the purpose of the Department's functions. In its response to the Committee's recommendations, the Department set out that it '…takes the view that to disclose taxpayers' confidential information in evidence to a Parliamentary Committee would be unlawful because it would hinder rather than help in the Department's function of collecting tax and therefore disclosure could not be regarded as for the purpose of the Department's functions'.[10] The Department's response did not explain in detail why disclosing taxpayer's confidential information would hinder its functions, or set out whether there would be any circumstances in which it would consider disclosure.

Examining the reasonableness of the settlements

1.13 To address concerns that there is little assurance over the reasonableness of the settlements reached by the Department, the C&AG reviewed the reasonableness of a sample of the larger tax settlements, using expert tax advice.[11]

9 HC Committee of Public Accounts, *HM Revenue & Customs 2010-11 Accounts: tax disputes*, Sixty-first Report of Session 2010–12, HC 1531, 20 December 2011, Conclusion and Recommendations.
10 Treasury Minute Cm 8305, Session 2010–12, 27 February 2012.
11 Committee of Public Accounts, Oral evidence, 17 October 2011, Q 230.

Settlements examined

1.14 We have examined five settlements. These are the settlements where there were substantive issues identified in the C&AG's 2011 Report and where the Committee of Public Accounts had specific concerns:

- The four cases where the Department used alternative governance arrangements (paragraphs 2.28 and 2.29 of the C&AG's Report and paragraphs 3 and 13 of the Committee's report).
- The case where the Department overlooked its established governance arrangements (paragraph 2.37 of the C&AG's Report and paragraphs 5 and 20 to 22 of the Committee's report).

1.15 Whistle-blowers have also expressed concerns about some of the large tax settlements reached by the Department. There has been significant press coverage of these concerns, and whistle-blowers have also made direct representations to the C&AG and the Committee. In selecting the cases to examine, and in examining the cases, we have sought to address the basis of these concerns.

1.16 The cumulative value of the five settlements is £3.6 billion. This includes cash sums payable as part of the settlement and general tax reliefs and allowances which would have had a value to the companies. This figure does not include any future revenue benefits accruing from the settlement.

1.17 The tax issues in all five of the cases involve applying tax law to very complex circumstances, including corporate structures, activities and trading that span international boundaries. The tax due depends upon the details of these corporate structures, their ownership and financing, and on the nature of the transactions, products and intellectual property involved. Determining the tax treatment requires an in-depth understanding of the contractual relationships, nature of costs, valuation of assets and sector practices. For example, three of the cases involved the Department challenging, and developing defensible alternative scenarios for, the companies' long-standing transfer pricing arrangements. The Department uses teams of tax and sector specialists to help resolve complex tax investigations.

1.18 The way that tax law applies to the complex facts in these cases is far from clear-cut. The Department used its judgement to decide how the law applied to the complex facts. In each case there was a range of justifiable positions the Department might have taken. Where the Department and the taxpayer disagree, they can either reach a compromise settlement, or they pursue the issues in litigation. This contrasts with the simpler tax affairs of small businesses or individuals where the law, and how it applies to the case, are usually clearer.

1.19 The five settlements were all concluded between 2008 and 2010. Two of the settlements involved accounting periods dating back to the mid-1990s. The other three covered accounting periods dating back to the late 1990s, or the early 2000s. Some of the tax issues therefore took more than a decade to resolve. In some cases, this is because the issue was in litigation, or awaiting the outcome of litigation in a similar case. The Department changed its approach to dealing with large business in 2006, and put more focus on resolving long-outstanding tax issues.

Issues examined and methodology

1.20 The C&AG engaged Sir Andrew Park, a retired High Court judge, to provide expert tax advice. As a barrister at Grays Inn tax chambers and later as a judge, Sir Andrew Park participated in many tax cases at all levels up to the House of Lords.

1.21 For each of the five settlements examined, the C&AG asked Sir Andrew Park to consider whether:

- the settlement value was reasonable in view of the circumstances of the case;
- the settlement was consistent with the Department's *Litigation and Settlement Strategy*;[12]
- the Department obtained appropriate legal advice and acted upon the advice at all relevant stages; and
- the Department followed its own procedures.

1.22 In concluding whether each settlement was reasonable, we primarily considered whether the settlement was too favourable to the taxpayer concerned and, consequently, whether that the Exchequer received less than it should have. Where the taxpayer fully conceded an issue, the settlement of that issue clearly is not at risk of being too favourable to the taxpayer. Where the Department substantially changed its initial assessment of the tax due in an issue, we have judged whether the settlement terms were reasonable.

1.23 In making this judgement, we have considered whether the settlement was not less than the Department might have been expected to obtain from litigation, considering the strength of the Department's case, the possible outcomes of the litigation and their likelihood, and the time and costs involved. Litigation is always uncertain, and it is not uncommon for decisions to be overturned at each stage of appeal. Assessing the outcome of litigation involves judgement. Where possible, we have assessed factors such as the credibility of expert witnesses for each side, as well as the technical arguments and the facts of the case, in making this judgement.

12 HM Revenue & Customs, *Litigation and Settlement Strategy*, 2007, available at: http://www.hmrc.gov.uk/practitioners/lss.pdf

1.24 We have also considered whether the settlement value appeared to be within the range permitted by tax law for the type of case involved. For example, in those involving transfer pricing issues, where there may be a wide range of tax values which would be compatible with tax law.

1.25 Figure 1 shows the rationale and criteria that we considered for each of the four questions examined.

Figure 1
Criteria in examining settled cases

Question	Why important?	Criteria for evaluation
Was the settlement value reasonable?	Large tax settlements are complex and there is no clear answer as to what represents the 'right' tax liability. The Department's governance processes in these cases provide limited assurance that the settlements were reasonable and not excessively favourable to the taxpaying company. The Department's interpretation of its statutory obligations is that it cannot provide details on these cases for confidentiality reasons. Thus, there is no transparency over whether these settlements represent good value for the Exchequer.	Does the settlement represent fair value for the Exchequer and the taxpaying community generally, rather than being favourable to the taxpayer? This includes considering whether the settlement was as good as, or better than, the outcome that might be expected from litigation, considering the risks, uncertainties, costs and timescale of litigation. Are the terms of the settlement lawful and is the settlement value within the range permitted by tax law?
Was the settlement consistent with the *Litigation and Settlement Strategy*?	The *Litigation and Settlement Strategy* sets out the Department's framework for concluding all tax disputes, and should be adhered to in all cases.	Did the Department consider each tax issue on its merits rather than as part of a 'package deal'? Were all-or-nothing issues settled on all-or-nothing terms, rather than splitting the difference? Was the settlement for not materially less than the Department could reasonably have expected to get through litigation?
Did the Department obtain and act on relevant legal advice?	The Committee did not feel that the Department satisfactorily answered its questions about the legal advice obtained in specific cases.	Was legal advice required? If so, did the Department obtain appropriate legal advice? Did the Department consider the legal advice when deciding to agree the settlement?
Did the Department follow its own procedures?	The Department has procedures for approving settlements which ensure that that they are independently reviewed before being agreed with taxpayers. If these procedures are not followed, there is a lack of assurance that the settlements are appropriate.	Were the settlements signed off by appropriately senior staff before being concluded? Were staff involved independent of the decision-making process?

1.26 Sir Andrew Park's primary methodology for his review was to examine the Department's case papers for each settlement. These included documentation setting out the facts and the technical issues involved; the Department's and the taxpayer's arguments; how the settlement negotiations had proceeded; and the details of the settlement agreement. He examined relevant legislation and case law in reaching his conclusions on each case. Where the taxpaying companies with whom the settlements were reached commented on the settlement, Sir Andrew Park considered their comments. He also took into account the concerns expressed by whistle-blowers.

1.27 Sir Andrew Park pursued his queries by submitting written questions and requests for clarification to the Department. He was content that he received full answers to all of these questions and that he had access to all the papers he considered necessary to conclude the review.

Taxpayer confidentiality

1.28 The C&AG is bound by Section 182 of the Finance Act 1989, which makes it an offence to disclose information about an identifiable taxpayer. Section 182 (6)(b) of this Act allows for lawful disclosure of such information if it is made for the purposes of the C&AG's functions. In deciding whether to disclose information about individual taxpayers, the C&AG must therefore consider whether it is necessary to make this disclosure in order to discharge his statutory functions.

1.29 This report focuses on the reasonableness of individual tax settlements and the Department's processes for reaching these. Whilst it is necessary to give some of the details of the tax issues under consideration to show how we reached our conclusion on reasonableness, the identity of the taxpayer is not central to making these judgements, or to assessing the Department's processes for reaching settlements. The C&AG considers that it is not necessary to identify taxpayers to report fully on the issues examined. For this reason, we have not named taxpayers, and refer to them in this report as Companies A to E, respectively. Where possible, we have also omitted details of the settlements that would reveal the identity of the taxpayer. In some cases, certain details of the settlements are already in the public domain and we recognise that these taxpayers may be identifiable.

1.30 Sir Andrew Park reported in detail to the C&AG on each of the settlements. These reports contain extensive confidential details about the disputed tax issues. Sir Andrew Park's reports allowed the C&AG to make a full judgement on the reasonableness of the settlements and the Department's processes for reaching settlement, and the C&AG set out these judgements and conclusions in this report. The C&AG considers that disclosing Sir Andrew Park's reports would breach taxpayer confidentiality.

Part Two

Findings

2.1 Sir Andrew Park reported his findings and conclusions for each case to the C&AG. His views form the basis of our conclusions on the reasonableness of the tax settlements.

2.2 Sir Andrew Park also considered how the Department reached each settlement and reported his findings and conclusions in respect of the other three questions set out in paragraph 1.21. His findings on these matters were consistent with the findings of the NAO's work on the C&AG's Report in July 2011, and further work conducted by the NAO as part of this review. Our overall conclusions are based on both Sir Andrew Park's findings and conclusions and those from our own work.

The reasonableness of settlements

2.3 Sir Andrew Park concluded that all five of the settlements were reasonable. He went further in case B, and concluded that the settlement was relatively advantageous to the Department. The issues in each case, and the factors he considered in concluding on the reasonableness, are set out in Appendix One. Taxpayer confidential information, and details that might identify taxpayers whose identity is not already public, have been removed.

2.4 The concerns raised by whistle-blowers were often based on a partial understanding of the settlement because the details were confidential. In this context, the concerns made sense. The conclusions on reasonableness depend upon an understanding of the settlement as a resolution of several issues, as well as the detail of the individual issues.

2.5 The Department decided to restrict the involvement of specialists in the final negotiations of some of the cases, which contributed to some of the concerns raised by whistle-blowers. For example, the Department's technical specialists were involved in the early stages of one case. Later in the negotiations, they were involved to a much lesser extent and the Department's senior tax specialists took over the negotiations. This led to some of the technical specialists feeling marginalised, and some had concerns over the settlements reached, which the Department did not deal with to their satisfaction. When these concerns were made public, public confidence in the Department's processes for reaching large tax settlements was significantly undermined. It also led to a loss of confidence among some of the Department's own staff, and damaged morale. Even if the senior Departmental staff used the expertise and had no further need to consult the specialists, the Department should have communicated the rationale for these settlements to its specialist staff more effectively.

2.6 Each of the four largest settlements was reached through an accelerated negotiation process between the Department and the company. These negotiation processes lasted between two and ten months. This involved the Department and the company applying significant staff resources and committing to resolving multiple outstanding tax issues to an accelerated timetable. Given that the settlements reached were reasonable, there were considerable benefits to having resolved the outstanding tax issues. The Department secured the tax yield. The companies had increased certainty over their tax affairs. The resolution of long-outstanding issues allowed both the company and the Department to focus on resolving disputed issues more quickly in the future.

2.7 Four of the cases involved either transfer pricing issues, or controlled foreign companies issues, or both. These generic tax issues are explained below. This illustrates the complexity of the issues involved, and why there is scope for different interpretations that result in different possible outcomes for the tax due. This contrasts with the situation smaller businesses and individual taxpayers face, where there is less room for alternative interpretations of tax law.

Controlled foreign companies

2.8 This covers situations where a UK parent company owns a subsidiary based in an overseas jurisdiction (often with a tax regime more favourable to the taxpayer). In certain circumstances, the profits of the subsidiary are assessed as part of the taxable profits of the UK parent company, thereby increasing the tax liability.

2.9 One of the key defences a taxpayer can use against being taxed under the controlled foreign companies provisions is the 'motive test' exemption. The legislation says that the profits of the subsidiary will not be assessed as part of the taxable profits of the UK parent company under the controlled foreign companies provisions if:

a "in so far as any of the transactions the results of which are reflected in the profits arising in that accounting period ...achieved a reduction in United Kingdom tax, either the reduction so achieved was minimal or it was not the main purpose or one of the main purposes of that transaction … to achieve that reduction; and

b it was not the main reason … or one of the main reasons for the company's existence... to achieve a reduction in United Kingdom tax by a diversion of profits from the United Kingdom."[13]

13 Income and Corporation Taxes Act 1988, Section 748 (3).

2.10 There is another key defence that a company can use against the application of the controlled foreign companies provisions to subsidiaries in European Community (EC) member states. This relates to freedom of establishment – the right to set up companies (including subsidiaries) in other EC member states. In the Cadbury Schweppes case, the European Court of Justice ruled on whether the UK's controlled foreign companies legislation applied to subsidiary companies in other EC member states.[14] The Court's judgement was that the controlled foreign companies legislation could be applied only in very narrowly defined circumstances. Companies can argue that the controlled foreign companies provisions cannot be applied because their circumstances are not within this narrowly defined range. The uncertainty over the application of these provisions is highlighted by the infraction proceedings that the EC has started against the UK in respect of its existing controlled foreign companies legislation.

2.11 In 2010, the Department developed a new approach to settling controlled foreign company cases. Under the previous approach, the UK company would be taxed on the whole of the profits of the controlled foreign company, with interest. The new approach allowed the controlled foreign company to pay a dividend to its UK shareholder, which would elect to pay tax on the dividend. If a sufficient proportion of the controlled foreign company's profits were charged to UK corporation tax in this way, it would be regarded as passing the motive test. The new approach allowed for the UK shareholder to be taxed on a 'deemed dividend' if the controlled foreign company could not pay an actual dividend. The dividend, or deemed dividend, would be taxed for the accounting period in which it was received, and so would generally not attract interest.

Transfer pricing

2.12 This issue arises where trading takes place between group companies, one of which is UK based for tax purposes, and one of which is not, and the trading is not on an 'arm's length basis'. In other words, trading is not on the impartial terms that would have been agreed between unconnected parties. If the terms of these transactions are disadvantageous to the UK company, then the transfer pricing legislation allows the taxable profits of the UK company to be adjusted. The adjustment recalculates the taxable profits as if the transactions were arm's length, thereby increasing the company's UK tax liability.

Transfer pricing – recharacterisation argument

2.13 This issue arises where trading agreements between group companies, one of which is UK based for tax purposes, and one of which is not, are not on an arm's length basis. Recharacterisation can only be used in limited and exceptional circumstances. It involves disregarding the contractual arrangement between the group companies for UK tax purposes and substituting an alternative relationship for the contractual relationship. The taxable profits of the UK company are recalculated on the basis of this alternative relationship, thereby increasing the tax liability. Whether the current legislation permits the recharacterisation approach is controversial and the approach has not yet been tested in litigation.

14 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd vs Commissioners of Inland Revenue, Case C-196/04, 12 September 2006.

The Department's processes for reaching settlements

2.14 This section considers whether the Department followed a reasonable process in reaching the settlements.

Were the settlements compatible with the Litigation and Settlement Strategy?

2.15 The *Litigation and Settlement Strategy* sets out the terms under which settlements may be reached. It does not set out the governance arrangements to be used in reaching settlements, rather the principles to be followed in resolving tax disputes. The Department introduced the *Litigation and Settlement Strategy* in 2007, and updated and reissued it in July 2011. As the five settlements we examined were all concluded between 2008 and 2010, we have considered compliance with the 2007 version of the strategy. Three of the terms for resolving settlements are of most relevance to the issues in dispute in these five cases. These are below, with emphasis added:

> '**Deal with each dispute on its own merits**. Do not enter into "package deals", in which a range of issues are settled for a single payment that is not subdivided amongst individual disputes.
>
> Some disputes have an all-or-nothing character, involving a single point of law that would be decided one way or the other by the courts, with no middle ground. Such disputes should be settled on all-or-nothing terms – **do not split the difference** or offer any discount for an agreement not to litigate. Similarly do not seek low value settlements in cases where we are not prepared to litigate.
>
> Where there is a dispute over facts or valuation – such as transfer pricing or the level of sales in a case with inadequate records – there will often be a range of plausible figures for tax due. Your best estimate **must not be materially less than you would reasonably expect to obtain from litigation**, though may be at the cautious end of that range.'[15]

2.16 We concluded that four of the settlements were clearly compatible with the *Litigation and Settlement Strategy*. In the settlement with company D, Sir Andrew Park considered that there may have been a sense in which the settlement could be characterised as 'splitting the difference', but his view is that, if this is the case, it is the strategy that is at fault rather than the settlement.

Package deals

2.17 None of the settlements involved package deals as defined in the *Litigation and Settlement Strategy*. All the disputed tax issues in each settlement were settled on their own terms, and there were no payments that were not allocated to a specific issue.

15 HM Revenue & Customs, *Litigation and Settlement Strategy*, 2007, Paragraph 14.

2.18 The definition of a package deal in the *Litigation and Settlement Strategy* does not prohibit settling an issue as part of a settlement of multiple issues on different terms than would be considered if the issue was settled by itself. For example, the settlement with company E is reasonable only in the context of being a settlement of several issues at once. Sir Andrew Park considered that had the National Insurance contributions (NICs) and interest been the only issues, the settlement would not have been reasonable.

2.19 The Department updated the *Litigation and Settlement Strategy* in July 2011, and added the requirement that each disputed issue should be considered on its own merits. The guidance accompanying the 2011 version of the strategy explains that this rules out the Department conceding one issue in return for the taxpayer conceding another. This fits better with an external perspective of a package deal. However, the reality is that once the Department and a taxpayer enter a process to resolve multiple issues at once, interdependency is created between these issues and the outcome for individual issues may be different when settled in a package with other issues.

Splitting the difference

2.20 On four of the cases, there was no evidence of 'splitting the difference' on any of the tax issues. The Department either negotiated for the best outcome it could or dropped the issue where it felt its case was weak. In the settlement with company E, Sir Andrew Park found that the interest on employer's NICs could be viewed as a separate tax issue so settling without the interest was not splitting the difference.

2.21 It is less clear that the settlement with Company D did not involve 'splitting the difference'. The issue in this case, controlled foreign companies, is an issue where the possible outcome is either that the taxpayer owes nothing or owes the full amount, so a settlement value of less than the full amount is not permitted under the *Litigation and Settlement Strategy*. The agreed settlement with company D was lower than the tax liability that would have been established if the Department won in litigation. Given the uncertainties and costs of litigation, it was reasonable for the Department to settle at the amount it did, but it is not clear that this is compatible with the *Litigation and Settlement Strategy*. Sir Andrew concluded that, if the settlement did not meet the requirements of the strategy clearly, the settlement was no worse for that.

Dispute over facts or valuation

2.22 Three of the cases involved transfer pricing issues. These are about the valuation of transactions, and therefore not 'all or nothing' disputes. These settlements all complied with the requirement in the *Litigation and Settlement Strategy* that the settlement should be not be materially less than might be expected from litigation.

Did the Department obtain and act on relevant legal advice?

2.23 The Department sought legal advice on some aspects of all of the cases. We considered whether the Department sought appropriate legal advice in the negotiation process leading to settlement, and on the terms of the settlement before they were agreed.

2.24 Sir Andrew Park noted that there is no need to routinely seek legal advice at this stage of the process, unless one of the issues is in litigation. The legal issues at this stage may be clear. This is either because the Department sought advice earlier in the case, or because the dispute is about other issues that the Department's other specialists are best placed to deal with, such as the facts of the case, or accounting or other technical matters.

2.25 The legal advice obtained in each case, and an assessment of whether this was adequate, is set out below:

Case A

2.26 The Department's lawyers were not involved in the final, accelerated negotiation procedures that led to this settlement. The Department's Solicitor's Office and counsel were involved when it looked as if the case might go to appeal, but did not participate during the accelerated negotiation process. Sir Andrew Park noted that this lack of involvement was entirely appropriate and that there was no need for lawyers to be involved when the issue was not in litigation.

Case B

2.27 The Department sought counsel's opinion on the draft settlement before it was concluded and acted in accordance with counsel's advice in concluding the settlement. Sir Andrew concluded that the procedure of obtaining counsel's opinion before finalising the settlement was exemplary.

Case C

2.28 The Department consulted counsel on four of the main issues in this case, either shortly before or during the accelerated negotiation process. The Department also consulted its Solicitor's Office on an issue of double taxation. The Department acted in accordance with the Solicitor's Office advice. Sir Andrew Park concluded that lawyers were brought into the case where it was desirable they should be.

2.29 The Department's Solicitor's Office gave their advice in this case orally. It was later summarised in writing (by the Department's senior responsible officer for the case who was not a solicitor) in the submission to commissioners asking them to approve the settlement. Sir Andrew Park noted that, while the Department was totally fair and reasonable to want to avoid double taxation in these circumstances, it was not easy to find a technical legal basis to justify the action. In paragraph 2.36 of the C&AG's Report, we stated that it would have been helpful to have had the legal advice confirmed in writing. Sir Andrew Park's review supports this conclusion. He considered that using the commissioners' collection and management powers[16] in this case must have stretched these powers to the limit, but he supports the agreement reached.

16 The commissioners have a limited discretion with regard to their duty for the collection and management of taxes under Section 5 of the Commissioners for Revenue and Customs Act 2005. In certain limited circumstances, they can forego the collection of tax, for example if there is a higher net return from not collecting the tax. The judgement in Wilkinson v Commissioners of Inland Revenue in the House of Lords 2005 set out the limits of the circumstances in which the collection of tax could be foregone.

Case D

2.30 The Department did not seek legal advice on whether the controlled foreign companies issue should be settled, or on the terms on which it should be settled. Lawyers were not involved throughout the settlement negotiations, but Sir Andrew Park noted that he could see no need for lawyers to have been involved at all stages. The Department consulted its Solicitor's Office on a detailed point on a tax avoidance scheme that was also part of the settlement.

Case E

2.31 At the time of the meeting at which the settlement was negotiated, there was ongoing litigation on the issue of employer's NICs. The Department should, therefore, have obtained legal advice before reaching a settlement, but it did not do so. The Department sought legal advice from its Solicitor's Office on the issue of whether the settlement agreed at that meeting was legally binding. The Department acted consistently with the advice.

Did the Department follow its own procedures?

2.32 We found the settlements in all five cases to be at least reasonable. In assessing compliance with procedures, we considered our previous review of the Department's governance arrangements, as reported in the C&AG's Report in July 2011.

2.33 The Department has since set out changes to its governance arrangements to address these concerns. If operated correctly, the changes should help to ensure that all cases comply with governance processes and that negotiation and sign-off of the largest settlements is adequately separated. The Department also proposes to review all large settlements before finalising them, and to review a sample of cases after settlement to assess whether they complied with governance procedures. These changes have the potential to restore confidence in the settlements the Department reaches, both for external stakeholders and its own staff.

2.34 The processes followed in each case are summarised below:

Case A

2.35 The settlement was agreed in principle at a high-level meeting between the company and senior departmental staff, including the Permanent Secretary for Tax. The Department did not produce a note of this meeting. The settlement proposal was signed off by two commissioners before the formal agreement was signed. The Permanent Secretary for Tax was one of these two commissioners.

2.36 The Department did not separate negotiation and sign off of this settlement. Sir Andrew Park noted that involving the Permanent Secretary for Tax in the high-level meeting was appropriate, given the magnitude and complexity of the issues involved. At the time, the other commissioners lacked detailed tax expertise, so there was no one else who could have represented the Department at this level. Given that this was the case, a different commissioner should have signed off the settlement. The Department has now committed to building the level of detailed tax knowledge among commissioners.

Case B

2.37 As in case A, the Permanent Secretary for Tax was present at the meeting with the company when the settlement was agreed in principle. There was a note of this meeting. The Permanent Secretary for Tax and one other commissioner signed off the proposed settlement before the formal agreement was signed.

2.38 The Department did not refer the settlement proposal to the High Risk Corporates Programme Board for approval, although it met the criteria for referral that were in place at the time.

Case C

2.39 The settlement proposal was signed off by two commissioners. In this case, neither of the commissioners had been involved in negotiating the settlement, so their sign off was an independent check on the settlement proposal.

Case D

2.40 The settlement was agreed in principle at a high-level meeting between the company, the Permanent Secretary for Tax, and one of the Department's other commissioners. The Department did make a brief note of this meeting.

2.41 The same two commissioners signed the final settlement agreement. Given their involvement in the negotiations, there was no separate authorisation of the proposed settlement before the formal agreement with the company was signed. The Department did not refer the settlement proposal to the High Risk Corporates Programme Board for approval, although it met the criteria for referral that were in place at the time.

Case E

2.42 The issues in this settlement were smaller in value than in the other four cases. Unlike those four cases, the Department did not set up specific governance arrangements in this case and it should have followed the standard governance processes.

2.43 The Department made a governance error in not realising that the settlement had to be approved by the Programme Board. The settlement was agreed in principle at a high-level meeting between the company, Permanent Secretary for Tax and other senior departmental staff. The Department did not inform the company at this meeting that the settlement depended on the Programme Board's approval. Sir Andrew Park's view is that in the circumstances the Department was probably bound by the settlement whether the Programme Board approved it or not.

2.44 The settlement proposal was subsequently put to the Programme Board, but they did not approve one element of it. The Department considered whether it should go back to the company to seek an additional payment for this element. It took legal advice on whether the settlement reached at the meeting with the company was binding. Following this, two commissioners and the Chair of the Programme Board met and decided it was not in the Department's best interests to reopen the settlement. The Department put the decision to the next meeting of the Programme Board, who agreed that accepting the settlement proposal was the correct approach.

2.45 The Department did not make a written record of the meeting at which it negotiated the settlement with the company. Nor did it make a record of the meeting of two commissioners and Chair of the Programme Board at which it made the important decision not to reopen the settlement. The rationale for the acceptance of the settlement proposal was set out in an email almost three months after the commissioners' decision.

Appendix One

Case Summaries

The tax issues in each of the five settlements, and the factors considered in concluding on the reasonableness, are set out below. Names, dates, and details of the issues and settlement terms have been anonymised to avoid identifying taxpayers.

Case A

Background

1 Company A is a UK-resident company. Case A concerns the UK tax issues arising when company A, or its UK subsidiaries, transferred intellectual property to subsidiary companies in another country. It transferred intellectual property on three separate occasions, into a different subsidiary company each time. The country in which these subsidiaries operated granted tax reliefs that were not available in the UK. The effect of this was that the profits of the overseas subsidiaries were taxed at a far lower rate than in the UK.

The tax issues

2 There were three main UK tax issues arising from the intellectual property transfers:

- Chargeable gains on transferring the intellectual property from the UK companies to the overseas subsidiaries.
- The application of the controlled foreign companies provisions to the profits of the overseas subsidiaries.
- Transfer pricing on intra-group transactions between the overseas subsidiaries and company A, or its UK subsidiaries.

The Department's technical arguments

3 The Department had been investigating the tax effects of the reorganisations for nearly ten years, and had started to prepare for litigation, when company A asked the Department to negotiate on the disputed issues. The resultant 'rapid negotiation process' lasted four months, at the end of which a settlement was reached.

4 The Department's arguments on each of the tax issues were:

- **Chargeable gains – capital losses** Company A routed one set of intellectual property transfers through a UK group company with large unrelieved capital losses. The Department did not question that the gains could in principle be offset against losses in this way, but it did question company A's valuation of the chargeable gains and unrelieved losses.

- **Chargeable gains – postponement** Company A structured the other two intellectual property transfers so as to postpone the chargeable gains resulting from disposing of the intellectual property. The intellectual property was transferred in exchange for shares in the two overseas subsidiaries that became the owners of the intellectual property. The company arranged the transfers so that the gains will only become chargeable when the shares of these overseas subsidiaries are disposed of by the company A group. The Department did not dispute that this had the intended effect of postponing the chargeable gains.

- **Controlled foreign companies** Although it had been exploring whether the controlled foreign companies provision would apply to the overseas subsidiaries, the Department did not pursue these arguments in the rapid negotiation process.

- **Transfer pricing** Company A and its UK subsidiaries continued to provide some services to the three overseas subsidiaries to which the intellectual property had been transferred. The Department argued that the price paid for these services was not on an 'arm's length' basis and that the taxable profits of company A and its UK subsidiaries should therefore be adjusted upwards.

- **Transfer pricing – recharacterisation argument** The Department had also been considering whether, for transfer pricing purposes, to recharacterise the actual transactions to reflect different transactions that would have occurred at arm's length. However, it did not pursue this extreme argument in the rapid negotiation process. The recharacterisation argument involved ignoring the fact that the overseas subsidiaries owned the intellectual property rights. This was on the basis that they would not own them if their relationship with company A was arm's-length. In calculating the taxable profits of the UK companies, hypothetical arm's-length transactions would be substituted for the actual transactions.

Resolving the issues

5 All three tax issues were resolved in the settlement reached at the end of the rapid negotiation process. The terms of the settlement for each issue are outlined below.

Chargeable gains

6 The settlement agreement included increasing the value of the intellectual property disposed of, and reducing the losses that these could be set off against. The combined effect was to increase company A's initial assessment of the gains chargeable to corporation tax by almost £300 million.

Controlled foreign companies

7 There was no adjustment as the result of the controlled foreign companies provisions, as the Department did not pursue these arguments.

Transfer pricing

8 The outcome of the transfer pricing issue was that company A and its UK subsidiaries were assessed on additional profits in the hundreds of millions. This was made up of several elements. For the first few years after the intellectual property transfers, the Department successfully argued that the overseas subsidiaries were still receiving substantial assistance from the UK companies. To take account of this assistance, company A agreed to a share of the profits of the overseas companies being added to the profits of the UK companies. It also agreed to an upwards adjustment to the 'cost plus' percentage price that was being charged by the UK companies. The Department successfully argued that there was a special feature of the services being provided by the UK companies, and company A agreed to the taxable profits of the UK companies being adjusted upwards to account for this.

9 In addition to these specific adjustments to taxable profits, company A agreed to pay a further sum of tax in the tens of millions as part of the settlement.

Sir Andrew Park's view of the reasonableness of the settlement

10 Sir Andrew Park's overall conclusion is that the settlement reached was a reasonable one for the Department to have made. In his view, each of the three issues was resolved on terms that represented a reasonable outcome.

Chargeable gains

11 Sir Andrew Park concludes that the Department had no basis on which to argue that company A's arrangements to offset the chargeable gains against losses did not in principle reduce the tax payable. The only issue at stake was the valuation of the gains and reliefs. He concludes that the adjustments to the valuation of the gains and reliefs were 'advantageous' to the Department, in the sense that they favoured the Department's position rather than the company's. He also notes that, if the overall settlement negotiations had failed, it is unlikely that company A would have accepted the adjustments that reduced the losses.

12 On company A's arrangements to postpone the chargeable gains for the other two intellectual property transfers, Sir Andrew Park agrees that there was no basis for the Department to challenge this arrangement.

Controlled foreign companies

13 Sir Andrew Park's opinion is that the Department's argument was unlikely to succeed if the issue had gone to appeal. Firstly, the facts of the case indicate that the European Court of Justice's decision on Cadbury Schweppes would have prevented the use of controlled foreign companies provisions. Even if the use of the controlled foreign companies provisions was not prohibited, Company A would have had a strong case for arguing that the exempt activities provision in the UK legislation would have applied.

Transfer pricing

14 Sir Andrew Park's opinion is that the Department achieved a good result on the transfer pricing issues, in terms of the agreed valuations. He also concludes that it was reasonable for the Department not to have pursued the recharacterisation argument.

15 Had the Department used the recharacterisation argument successfully, it would almost certainly have resulted in a larger adjustment to company A's taxable profits than agreed in the settlement. However, Sir Andrew Park's view is that the issue would have gone to litigation, and the outcome of such litigation was wholly uncertain. It would also have been a very lengthy and expensive process. The litigation would almost certainly have gone all the way to the Supreme Court, the hearings would have been long and expensive and the whole process would probably have taken years.

16 In addition, Sir Andrew Park's view is that it is unlikely that company A would have agreed the other issues in the settlement if the Department had tried to use the recharacterisation argument. These issues would have gone to litigation and company A would probably not have conceded some of the major points agreed to in the settlement (for example, on the valuation of chargeable gains).

Case B

Background

17 Company B is a UK-resident company, and subsidiary B is its fully owned subsidiary. Subsidiary B is incorporated in, and operates in, an overseas jurisdiction. The rate of tax applying to subsidiary B in the overseas jurisdiction is very low. Company B granted exclusive licences to subsidiary B, giving subsidiary B rights over certain products, in return for lump sum and contingent payments to company B. The overall effect of granting the licences was to shift the costs, risks and rewards of the products from company B to subsidiary B.

The tax issues

18 The main UK tax issues were: applying the UK transfer pricing provisions to the transactions between company B and subsidiary B; and the application of controlled foreign companies provisions to the profits of subsidiary B.

The Department's technical arguments

19 The Department had been investigating the tax issues for over ten years. Following a long period of documentation review, company B and the Department agreed to try to negotiate a settlement before commencing litigation. The Department agreed, but continued to prepare for litigation in case the negotiations failed. The resultant 'accelerated negotiation process' lasted for several months, at the end of which they reached a settlement.

20 The Department's arguments on each of the tax issues were:

- **Transfer pricing** The Department argued that the lump sum and contingent payments made by subsidiary B to company B were below arm's length market rates. It wanted to recalculate company B's taxable profits by substituting arm's length payment rates for the actual payments made. Company B argued that the payments were already at arm's length rates.

- **Transfer pricing – recharacterisation argument** The Department argued that if company B and subsidiary B had been independent parties, they would not have entered into the licensing agreement at all; there would have been a different contractual arrangement. In calculating the taxable profits of company B, the Department wanted to disregard the actual contractual relationship with subsidiary B and recalculate company B's profits as if it had a different relationship with subsidiary B.

- **Controlled foreign companies** The Department argued subsidiary B was a controlled foreign company because of the low tax rate applying to subsidiary B in its overseas home jurisdiction, and because none of the exemptions applied. Therefore subsidiary B's profits should be allocated to company B, and subject to UK corporation tax.

Resolving the issues

21 The Department did not pursue either the controlled foreign companies argument or the recharacterisation argument in the accelerated negotiation process with company B. The subject of the negotiations was how to re-price the actual transactions that took place. Had the negotiations failed and the case gone to litigation, the Department would still have been able to consider using both the controlled foreign companies and the recharacterisation arguments. In the event, the Department and the company reached a negotiated settlement and this contained adjustments to transfer pricing.

22 The negotiations drew on material prepared by both the Department and company B, including an economic model for the transfer pricing adjustments.

23 The settlement comprised past and future elements. The past element covered the profits of company B from when it granted the first licence to subsidiary B until the year of settlement. The transfer pricing adjustments agreed for this period increased the corporation tax, and interest, payable by company B by several hundreds of millions of pounds.

24 The future element was an advance pricing agreement, which committed company B to further transfer pricing adjustments for future years. The Department assessed the net present value of the additional tax payable under this part of the agreement as several hundred million pounds.

Sir Andrew Park's view of the reasonableness of the settlement

25 Sir Andrew Park's overall conclusion is that the settlement reached was not only a reasonable one, but that it was relatively advantageous to the Department. He comments that it is possible that, if the case had been fought through the courts, the Department would have emerged with a better outcome, but he doubts it. He concludes that it was justifiable for the Department to have settled the dispute rather than taken it to litigation.

The transfer pricing adjustments agreed in the settlement

26 Sir Andrew Park notes that the Department provided full and careful instructions to counsel, and that counsel in turn considered the matters fully and in depth. Given the scope of his review, Sir Andrew Park could not consider all the extensive evidence prepared for the hearing. From the key documents he did see, his initial reaction was that company B's arguments seemed more persuasive than the Department's. Overall, he concludes that it was reasonable for the Department to settle the issue rather than litigate.

Controlled foreign companies

27 Sir Andrew Park's opinion is that the Department's argument was weak on the facts of the case, and was unlikely to succeed if the issue had gone to appeal. It was therefore reasonable for the Department not to have pursued this argument.

Transfer pricing – recharacterisation argument

28 Sir Andrew Park's opinion is that it was reasonable for the Department not to have pursued the recharacterisation version of the transfer pricing argument. The recharacterisation argument had not been tested in litigation. Sir Andrew Park's opinion was that applying the argument to company B would not have maximised the Department's chances of successfully upholding the recharacterisation argument.

Case C

Background

29 Company C is the UK-resident parent company of group C, a large group of companies, with subsidiaries in the UK and many other countries. There were many unresolved UK tax issues within group C, some going back nearly 20 years, when it began negotiations with the Department. The negotiations lasted ten months, at the end of which the Department and the company reached a negotiated settlement, which resolved almost all of the tax issues.

The tax issues

30 The negotiations involved numerous tax issues relating to multiple subsidiary companies within the group. The issue with the largest amount of tax at stake was transfer pricing on transactions between company C or its UK subsidiaries, and overseas subsidiaries. The next largest issue was the application of controlled foreign companies provisions to the profits of overseas subsidiaries. There were also three significant domestic tax issues: valuing a capital loss; classifying certain types of spending; and whether certain asset disposals were capital or revenue in nature.

The Department's technical arguments

31 The Department's arguments on each of the major tax issues were as follows:

- **Transfer pricing** Group C believed that the transactions with its overseas subsidiaries were already priced at arm's length rates. The Department's position was that they were not, and for tax purposes, should be increased.
- **Repatriation of profits** There was another issue related to the transfer pricing adjustments. If group C did agree a transfer pricing adjustment, the Department wanted group C to repatriate funds equivalent to the adjusted profits. This was so that the overseas subsidiary could not continue to invest its retained earnings by lending funds back to the UK. Group C agreed to repatriate those profits to the UK as part of an overall settlement, provided a way could be found to avoid repatriation resulting in group C being taxed a second time on these transactions. The Department agreed that this was reasonable and sought legal advice.
- **Controlled foreign companies** In group C, there were 11 significant overseas subsidiaries, and a larger number of much smaller overseas subsidiaries. The Department considered that these potentially qualified as controlled foreign companies which did not satisfy any of the exemptions from that regime. Group C's initial position was that there was no liability arising from controlled foreign companies.

- **Capital loss** The Department agreed that group C could claim a capital loss arising from an earlier transaction but disagreed with its method for calculating the loss, arguing that the loss was substantially lower.
- **Classifying spending** Group C claimed that some of its expenses qualified for a particular type of favourable tax treatment. The Department argued that not all of these expenses met the qualifying conditions.
- **Asset disposals** The tax treatment of transactions relating to the sale of five assets had not been resolved. Group C claimed that all of the sales were capital in nature, and so the proceeds could be offset against capital losses it had available. The Department were not convinced that group C had proved that the sales were capital.

Resolving the issues

32 The settlement reached covered all of the above issues. The terms of the settlement for each issue are outlined below.

Transfer pricing

33 The settlement agreement included a deemed increase in the consideration already paid, and a statement of expectation that the company would continue to file on the same basis. The transfer pricing adjustments agreed for the transactions to date increased the corporation tax, and interest, payable by company C by almost three quarters of a billion pounds. The agreement stated that this payment also discharged any tax liability arising on repatriated profits.

Controlled foreign companies

34 The Department agreed the tax treatment of the smaller subsidiaries early in the negotiations. Company C agreed that it was taxable on the profits of some of these. For the remainder, the Department agreed that one of the exemptions to the controlled foreign companies legislation applied.

35 Two of the larger subsidiaries were left out of the settlement because they were based in the EC and it was agreed to await the results of litigation in the Vodafone case, which dealt with similar issues. Company C conceded that it was taxable under the controlled foreign companies provisions upon the profits of all nine of the remaining larger subsidiaries. The total additional net UK tax liability agreed under the controlled foreign companies provisions was in the low hundreds of millions.

Capital loss

36 Company C conceded the issue and a capital loss was agreed at the amount that the Department had been arguing for. The loss agreed was several billion pounds lower than the loss that company C had been arguing for. There will be no tax effect until company C runs out of other unused capital losses and starts to use this loss.

Classification of spending

37 A proportion of the spending that company C claimed qualified for favourable tax treatment was agreed to qualify, but a higher proportion was agreed not to qualify.

Asset disposals

38 Four of the asset disposals were agreed to be capital in nature and one to be revenue. The classification as capital was a more favourable tax treatment from company C's perspective.

Sir Andrew Park's view of the reasonableness of the settlement

39 Sir Andrew Park's overall conclusion is that the settlement reached was a good one and represented fair value for the taxpaying community.

Transfer pricing

40 Sir Andrew Park's view is that the transfer pricing agreement seems to have been a good deal for the UK Exchequer. The adjustments agreed brought in a very substantial amount of additional tax. The Department's transfer pricing experts were involved and they obtained counsel's opinion. The negotiations over the transfer pricing adjustments were thorough on both sides, implying that both parties had fully considered the issues. Additionally, there is an indication that one of company C's own technical team felt the adjustments were excessive, implying that they were a good result for the Department.

41 Sir Andrew Park concludes that the Department was totally fair and reasonable in wanting to avoid double taxation when profits already taxed under transfer pricing adjustments were repatriated. He comments that the exercise of the commissioners' collection and management powers[17] in this case must have stretched these powers to the limit to avoid the double taxation, but he supports the agreement reached.

Controlled foreign companies

42 Group C conceded that all nine of the larger subsidiaries were controlled foreign companies, which was clearly a good result for the Department. The Department considered the status of each of the smaller companies individually. Sir Andrew Park praised the way that the Department persevered in the negotiations, settling two of the larger controlled foreign companies late in the process. He said that it "says a lot about the thoroughness and determination with which the Department's negotiators defended the interests of the Department."

17 The commissioners have a limited discretion with regard to their duty for the collection and management of taxes under Section 5 of the Commissioners for Revenue and Customs Act 2005. In certain limited circumstances, they can forego the collection of tax, for example if there is a higher net return from not collecting the tax. The judgement in Wilkinson v Commissioners of Inland Revenue in the House of Lords 2005 set out the limits of the circumstances in which the collection of tax could be foregone.

Capital loss

43 Group C conceded on this issue, and the valuation agreed was the one that the Department initially proposed. Sir Andrew Park's opinion is that the Department's analysis of the legislation was correct and group C were right to concede this point. The Department had obtained advice from counsel which supported their position.

Classification of spending

44 The Department had counsel's opinion supporting their case. Sir Andrew Park's opinion is that the settlement of this issue was reasonable for both sides, but if anything favoured the Department.

Asset disposals

45 Both sides had sought counsel's opinion. Sir Andrew Park's opinion is it was better to have settled these issues than litigate them. The outcome had the issue gone to litigation would have been largely unpredictable. On a tentative examination of the facts for the largest item, he considers it was probably right for the Department to have conceded that it was capital in nature.

Case D

Background

46 Company D is the UK-resident parent company of subsidiary D, a company incorporated in a country in the EC. Subsidiary D in turn had a subsidiary, subsidiary DD, in a different European country, which held all the shares in a company that the group had acquired via a shares-for-shares exchange. This resulted in subsidiary DD being indebted to subsidiary D, and making billions of euros of interest payments to subsidiary D. Subsidiary D did not pass its interest receipts on to company D in the UK.

47 Subsidiary D initially operated mainly through a branch in another European country (neither the country in which it was incorporated nor the country in which subsidiary DD was based, and not itself an EC country). It later transferred these activities to the country in which it was incorporated. The interest received by subsidiary D was chargeable to tax in each of these countries but, due to low tax rates and the availability of tax reliefs in these countries, it was paying little or no tax in either.

The tax issues

48 The main tax issue was whether the controlled foreign companies provisions applied to subsidiary D. If so, then company D would be subject to UK tax on subsidiary D's profits, the most significant part of which were the interest payments received from subsidiary DD.

49 Company D had other subsidiaries based in the same country as subsidiary D. The Department also considered whether the controlled foreign companies provisions applied to these subsidiaries and these were covered by the settlement. As the amounts involved were much smaller than for subsidiary D, we refer principally to company D in this case summary.

The Department's technical arguments

50 The Department began investigating the issue almost a decade before it reached a settlement, opening a formal enquiry two years after it began to investigate the issue. The Department argued that, under the controlled foreign companies provisions, company D was liable to UK corporation tax on the large interest payments received by subsidiary D.

51 Company D had two defences against the application of the controlled foreign companies provisions, both of which the Department opposed. Firstly, company D argued that the motive test exemption in UK law[18] applied. Secondly, it argued that, because subsidiary D was incorporated in an EC member state, the freedom of establishment articles in the EC Treaty prohibited the use of the controlled foreign companies provisions by the UK.

18 As set out in Section 748 (3) of the Income and Corporation Taxes Act 1988.

52 Company D applied to the Special Commissioners[19] to have the Department's enquiry closed. The Special Commissioners referred the case to the European Court of Justice on the question of whether the UK's controlled foreign companies provisions were inapplicable to subsidiaries based in EC member states. The European Court of Justice never gave a decision on this issue in company D's case. This was because it already had two references on the same issue. The lead case on the issue was the Cadbury Schweppes case and the European Court of Justice gave its decision on this in September 2006.[20]

53 The European Court of Justice's decision did not say that controlled foreign companies provisions could never be used where the subsidiary was incorporated in another EC member state. However, it did say they could only be used in narrowly defined circumstances. Company D now argued that the UK's controlled foreign companies provisions could not ever be interpreted as being within these narrowly defined parameters, and so could not be applied at all to companies established in EC member states. The Department argued that they could. The Special Commissioners considered this issue and ruled in favour of the Department.

54 Company D appealed to the High Court, where the decision was reversed. The Department appealed to the Court of Appeal, which reversed the decision reached in the High Court. Company D applied for leave to appeal to the Supreme Court but were denied this. This meant that company D had lost the argument that the UK could never apply its controlled foreign companies provisions to a subsidiary in an EC member state.

55 Despite losing this case, Company D still had two defences against the application of the controlled foreign companies provisions. The first was the argument it had had all along that it qualified for the 'motive test' exemption in UK law. The second came from the Cadbury Schweppes decision that the UK's controlled foreign companies provisions could only be used in narrowly defined circumstances. Company D argued that its circumstances were outside the restricted range set out in the Cadbury Schweppes decision. Had it chosen to do so, company D could have litigated either of these arguments rather than reaching a settlement. Success on either would have resulted in company D establishing that it had no liability to pay any tax under the controlled foreign companies legislation.

Resolving the issues

56 On losing leave to appeal to the Supreme Court, company D did not litigate either of its two arguments. Instead, having set out a detailed description of the relevant facts and circumstances in the case, with substantial supporting documentation, it negotiated with the Department to try to resolve the controlled foreign companies issue.

19 The Special Commissioners considered tax appeals before the introduction of the Tax Tribunals.
20 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd vs Commissioners of Inland Revenue, Case C-196/04, 12 September 2006.

57 Company D was only one of several major companies that had long-running disputes with the Department over the application of the controlled foreign companies provisions. To try to resolve these disputes, the Department developed a new approach to settling controlled foreign companies cases. Under the previous approach, the UK company would be taxed on the whole of the profits of the controlled foreign company, with interest. The new approach allowed the controlled foreign company to pay a dividend to its UK shareholder, which would elect to pay tax on the dividend. If a sufficient proportion of the controlled foreign company's profits were charged to UK corporation tax in this way, it would be regarded as passing the motive test. The new approach allowed for the UK shareholder to be taxed on a 'deemed dividend' if the controlled foreign company could not pay an actual dividend. The dividend, or deemed dividend, would be taxed for the accounting period in which it was received, and so would generally not attract interest.

58 The Department had advice from its Solicitor's Office that this approach was compatible with the *Litigation and Settlement Strategy* and it was this approach that was applied in settling company D's case. The main issue was what size of dividend would be acceptable to both the Department and company D. The new approach to controlled foreign companies contained an indication of what proportion of taxable profits would be acceptable as a dividend, but the amount would depend upon the circumstances of each case.

59 The Department reached a settlement with company D after four months of negotiation. Company D agreed to pay well over a billion pounds to cover the controlled foreign companies issue. The Department made various adjustments for tax allowances and other elements of the settlement, resulting in a much lower cash settlement figure, which still exceeded a billion pounds.

60 The settlement also included an agreement that, for certain future accounting periods, the Department would not treat subsidiary D, and other relevant subsidiaries of company D, as companies to which the controlled foreign companies provisions applied. This was conditional on the circumstances of the relevant companies, and UK tax law, not changing. In reaching this agreement, one of the factors that the Department considered for this period was that the company had repatriated very large sums to the UK, and agreed to repatriate further funds to the UK. The earnings on the repatriated funds would be subject to UK corporation tax.

Sir Andrew Park's view of the reasonableness of the settlement

61 Sir Andrew Park's overall conclusion is that the settlement reached was a good one and represented fair value for the wider taxpaying community. Had the Department not reached a settlement, the case would have gone to litigation. In Sir Andrew Park's opinion, company D had a good chance of winning both of its two arguments: the motive test defence and the Cadbury Schweppes defence. If it had won on either of these, the outcome would have been that it had no tax liability at all relating to subsidiary D's interest income.

62 Sir Andrew Park also concludes that it was reasonable for the Department to confirm that for future accounting periods it would not treat subsidiary D as a company to which the controlled foreign companies provisions applied. The controlled foreign companies provisions can apply for some accounting periods but not others, if there is a relevant change of circumstance. The Department considered that because company D was repatriating funds to the UK, that the profits of subsidiary D should no longer be apportioned to company D under the controlled foreign companies provisions.

63 The Department wrote to company D to confirm its proposed future treatment of subsidiary D and the other subsidiaries. This letter made clear that the proposed future treatment was dependent on neither the facts of the case nor relevant tax law changing. Sir Andrew Park notes that such letters are common practice and are useful aspects of tax management. If circumstances or tax law change, it is open to the Department to reassess the tax treatment. In the meantime, it gives the taxpayer useful clarity on how their tax circumstances will be treated.

64 Sir Andrew Park also assesses the lack of interest paid by company D. Company D paid most of the tax agreed around the time of the settlement, but the Department agreed that the company could pay the remainder over a five year period. Two issues arise in connection with interest: the interest for the accounting periods that subsidiary D was deemed to be a controlled foreign company up until the time of settlement, and interest on the instalments over the five years from settlement date.

65 Sir Andrew Park notes that the lack of interest is consistent with the Department's new approach. Under this approach, the controlled foreign company pays a dividend and the UK parent company elects to be taxed on the dividend. The tax is therefore due when the dividend is paid, rather than when the underlying profits arose. This is why there was no interest on the payment made around the time of the settlement.

66 A similar reasoning could be used on the instalments payable over five years. However, the dividend was notional or deemed and Sir Andrew Park attaches more weight to the negotiated settlement process. Company D had reached the maximum figure they were prepared to pay, and if the Department had demanded additional interest, there was a major risk that there would have been no settlement. He concludes that the Department were right to settle at this amount because, if the case had not been settled, it would have gone to litigation. If this had happened, there was a substantial risk that the Department would have received nothing.

Case E

Background

67 Company E is a UK-resident company, and part of a multinational group of companies, group E. The Department arranged a meeting with company E's senior staff with the aim of agreeing a way of resolving company E's outstanding tax issues.

The tax issues

68 The Department and the company considered six tax issues in the meeting:

- The payment of employer's National Insurance contributions (NICs) on adjustable share options granted by company E to employees under a plan used by the company more than a decade previously. Company E argued that under the plan, employer's NICs were not payable. The Department argued that they were.
- Interest on the employer's NICs if they ought to have been paid.
- Three other technical issues that arose from the specialised nature of company E's business. Company E and the Department had been exchanging arguments on these issues for some time.
- An issue where the Department was considering challenging what company E (in common with many other companies) had assumed to be the tax treatment of an aspect of its employment arrangements.

69 The amounts of tax in dispute in each of the first five issues were all in the tens of millions. The disputed sums of tax were similar, although the interest on the employer's NICs was slightly lower. (There is a possibility that the amount in dispute under one of the technical issues was significantly larger than the amounts in dispute in the others).

70 The final issue on the tax treatment of the management structure did not have a figure placed upon it. It seems likely that the Department were considering changing the tax treatment for the future of aspects of the employment arrangements. They had not indicated that they would be claiming additional tax for past years.

The Department's technical arguments

71 At the time of the meeting, at least one of the tax issues had been in dispute for over a decade. The Department's technical arguments on the issues were:

- **Employer's National Insurance contributions** For a time, many of the staff who served company E were employed by an overseas affiliate. Company E established an employee benefit trust which awarded options over shares in specially created companies as bonuses to the employees. The companies had little value when the options were awarded, and therefore neither did the options. Company E structured the employee benefit trust so that if the employees later came to exercise their options and acquire shares in those companies, these shares would have a cash value upon redemption. The overseas affiliate and company E argued that employer's NICs should be assessed on the value of the options at the time they were granted, and therefore very little, or no employer's NICs were due. The Department argued that employer's NICs were chargeable on the amounts for which the employees exercised their options, which had a value in the low tens of millions. There was also an issue of whether, even if the Department was right in principle, they had claimed the NICs from the right company in the company E group.

- **Interest on employer's NICs** Some years before its meeting with company E, the Department had reached settlements with over 20 other companies using the same share options scheme. The settlement that the Department agreed with these companies was that the companies would pay the employer's NICs liability in full, but would not pay any interest relating to the late payment of this liability. Company E was offered the same settlement terms at the time, but refused them.

Resolving the issues

72 There had been some litigation between company E, its overseas affiliate, and the Department on the employer's NIC issue. This concerned whether the Department had assessed the employer's NIC liability on the correct group E company. The Department had assessed the liability on company E itself. Company E argued that the Department should have assessed the overseas company that was the contractual employer of those receiving the share options. This mattered because the time limit for making an assessment had passed. If company E was not the right company to have assessed, the Department could no longer have claimed the liability from the overseas company.

73 At the time of the meeting with company E, the First-tier Tribunal had ruled that the Department had assessed the correct company, but company E was appealing this decision. There had not yet been any hearings on the main issue of whether the employer's NICs were payable at all. Other companies that had implemented the same plan had conceded that the employer's NICs were payable but company E was still arguing that they were not.

74 At the meeting with company E, the issues were settled as follows:

- **Employer's NICs** Company E agreed to pay the full liability.
- **Interest on employer's NICs** The Department agreed not to charge interest on the employer's NICs liability.
- **The three technical issues** Company E conceded two of these issues. The Department conceded the other.
- **Employment arrangements issue** The Department agreed to discontinue their investigation of this issue.

75 The result of the agreement was that a large sum (partly employer's NICs and partly corporation tax) was payable by company E. The Department believe that there was also significant additional intangible benefit to having resolved the issues, in that they would be able to resolve disputed issues more quickly in the future.

76 Following the meeting at which these terms were agreed, the Department realised that its own governance processes required the settlement to be approved by the High Risk Corporates Programme Board (the Programme Board). This was because the settlement met the criteria for referral: the cumulative tax under consideration in the settlement exceeded £100 million, and the Department was proposing to concede one or more of the issues.

77 The Department referred the settlement to the Programme Board, who approved it, apart from the element relating to interest on the employer's NICs. The Programme Board felt that interest should be charged from the time that the other companies using the scheme settled, because otherwise company E would have benefited from the delay in settling the issue.

Sir Andrew Park's view of the reasonableness of the settlement

78 Sir Andrew Park noted that several things went wrong in the process by which the settlement was agreed. Despite the significant procedural issues, Sir Andrew Park's conclusion is that the overall settlement reached was reasonable considering all the circumstances. Had the only issue been settling the employer's NICs liability and charging related interest, he would not have viewed the settlement as a reasonable one. However, when the settlement is viewed as one settlement covering six issues, including the interest issue, it was reasonable.

79 The alternative to reaching a settlement would have been to litigate all the issues. Sir Andrew Park noted that the Department might have secured a better outcome had all the issues gone to litigation, but equally they might have done worse. He also cites the other benefits of reaching a settlement, which cannot be evaluated in monetary terms but are nevertheless important. These include normalising the relationship between company E and the Department.

80 There were five issues where specific sums of money were in dispute. The Department succeeded on three. As company E paid the full amount the Department argued for on these issues, there is no question that this was not a reasonable outcome for the Department. That leaves the two issues that the Department conceded: interest on the employer's NICs and one of the technical issues. The technical issue was highly specialised and Sir Andrew Park did not feel able to predict which way it would have gone if it had been fought out on appeal. On the management structure issue, his view was that the Department would have been unlikely to succeed if it had pursued it further.

81 On the interest on employer's NICs, Sir Andrew Park considered whether it was open to the Department to demand payment of the employer's NICs liability but not charge interest on that liability, especially given that the Department had written to company E (as part of its offer to settle with all scheme users) warning them that interest would continue to accrue on the liability if they did not settle. Sir Andrew Park noted that not charging interest was technically possible. This is what happened when the other companies settled.

82 Once the issue of interest is seen as separate from the issue of whether the liability is due, it can be viewed as part of a wider settlement like any other tax issue. Viewed in this way, a concession on interest may be what led company E to settle the other issues. In this scenario, the overall amount agreed under the settlement might have been higher than if the Department had demanded the interest. This would have been either because company E would not have agreed to settle the other issues, or because it would have conceded fewer of them. Therefore, it could have been reasonable not to charge interest because otherwise a settlement may not have been reached, or if it had, it would have been of a lower value.

83 However, if the employer's NICs issue had been the only tax issue in dispute, it would have been very difficult for the Department to justify a settlement whereby company E paid the NICs without interest, considering the settlement five years earlier with 20 other companies.

Interest on the employer's NICs

84 The Department have stated that, at the meeting with company E, their officials believed there was some barrier to charging interest. Sir Andrew Park thinks there was no such barrier. First, the Department had included the interest in a County Court claim to recover the employer's NICs. This claim was adjourned while the issue of whether employer's NICs were payable or not was considered by the Tax Tribunals, but would have been enforceable had the Department won that litigation. Second, the Department had written to company E as part of its offer to settle the issue with all scheme users. In that letter, it stated that interest would continue to accrue if litigation was necessary. Finally, the Programme Board could not have concluded that interest should be charged from the time that the other companies settled had they been aware of a barrier.

85 Given that there was no legal barrier to charging interest, Sir Andrew Park concluded that the agreement reached at the meeting with company E to not charge interest was a deliberate decision that made sense in the context of reaching a settlement on all the issues under consideration. He accepts that officials of the Department may genuinely have believed that there was a barrier.

86 The Department did not check whether interest on employer's NICs was chargeable before meeting company E. Nor did they check the position before agreeing to waive the interest in their meeting with company E. This supports Sir Andrew Park's conclusion that the decision not to charge interest was a deliberate one.

Errors in process

87 Although the settlement itself was reasonable, Sir Andrew Park finds that there were significant errors in the process of reaching the settlement. The main error was that, at the time of the meeting with company E, the Department's officials did not realise that the Department required the settlement to be approved by the Programme Board. The Department therefore did not mention to company E that the settlement depended on this approval.

88 After the Programme Board had decided that interest should be charged on part of the time that the employer's NICs was outstanding, the Department informed company E that this element of the settlement had not been approved. Company E said that they believed that the settlement reached at the meeting was binding, and the Department had not mentioned the role of the Programme Board to them.

89 The Department took advice from its Solicitor's Office on whether the agreement reached at the meeting was binding, or should be reopened to allow the Department to seek payment of interest. The advice was that it was legally permissible for the Department to either ask company E to pay interest, or for the Department not to.

90 Following this advice, two of the Department's commissioners and the Chair of the Programme Board met and decided that it was in the best interests of the Department, and of taxpayers generally, not to seek to reopen the agreement with company E. The settlement agreed at the meeting with company E was therefore implemented unchanged.

91 Sir Andrew Park's view is that the agreement reached at the meeting was almost certainly legally binding as the settlement was with three of the Department's top officials, and company E were given no indication that this agreement depended on anything else, such as the Programme Board's approval. Had the Department reopened the settlement, there may well have been legal proceedings. He concludes that the Department were right not to reopen the settlement negotiated at the meeting with company E.

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