

EUROPEAN U.S. TAX DESK NEWSLETTER

April 2017



IN THIS ISSUE!

Welcome to the third issue of the Mazars European U.S. Tax Desk Newsletter!

This is our new series of regular European tax newsletters. These will provide you with insights on current topical tax issues and discuss how they will affect you.

In this edition, our contributors from 5 European countries discuss:

- agreement on proposed hybrid mismatches;
- multilateral instrument to implement BEPS measures into bilateral tax treaties;
- new permanent establishment guidelines;
- Luxembourg transfer pricing circular on financing activities, applicable to the transfer pricing documentation and APA related to financing margin;
- The opinion of the Advocate General at the CJEU presented on 19 January, 2017 on the Eqiom case (C-6/16) on dividend payment from France to Luxembourg;
- Fiscal impact of selling shares in a limited liability company (“GmbH”) at a discount to the GmbH itself; and
- Investing in the UK now that Brexit has been commenced.

On behalf of the Mazars European U.S. Tax Desk, we hope you find our newsletter useful. If there are any issues you would like to discuss further, please do not hesitate to contact us.

HERE TO HELP YOU!

International firms with a competitive advantage have real time access to insightful foreign tax knowledge. The right advisor helps to identify opportunities and to manage risk profiles. Given the far reaching effects of the OECD BEPS project, awareness of legislative and regulatory changes has never been more important.

The Mazars US Tax Desk was created to help US companies successfully manage these challenges. We can help you to ask the right questions, set priorities and define the action plans needed to succeed in the fast moving landscape of international tax.

The Mazars US Tax Desk is a platform for companies with existing European operations and those looking to enter Europe.

In working with the Desk, companies will be able to access a wealth of multifaceted, cross border experience in areas such as:

- International tax structuring
- Transfer pricing
- Inbound and outbound investment
- Intellectual property planning
- Financing structuring
- Treaties – interpretation and maximisation of benefits
- Research and development tax credits
- Cross border financing, leasing and licensing
- Corporate acquisitions and divestments

We are here to help you! As part of our programme to keep you up to date on what is happening in Europe, we will publish regular newsletters. These will discuss important tax legislative changes, provide on the ground insight, but most importantly, identify how this news is of relevance to you.

We hope you enjoy our newsletter. Please do not hesitate to contact any of the Desk members if you have a particular issue you would like to discuss further.

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THE NETHERLANDS

EU MEMBER STATES REACH AGREEMENT ON PROPOSAL HYBRID MISMATCHES

On 21 February 2017, the EU Member States unanimously agreed on the proposal for a Directive ('ATAD 2') which lays down rules against hybrid mismatches involving third (non-EU) countries. ATAD 2 is an amendment to the earlier agreed upon Anti-Tax Avoidance Directive on 20 June 2016 which contains rules to tackle hybrid mismatches. ATAD 2 extends the scope of these rules.

ATAD 2 intends to broaden the scope to:

- A large variety of other mismatches which are not addressed in the Anti-Tax Avoidance Directive, such as hybrid permanent establishment mismatches, hybrid transfers, so-called imported mismatches and dual resident mismatches; and
- Mismatches between Member States and third countries.

ATAD 2 is to be implemented as of 31 December 2019 with the exception of the rules concerning mismatches between Member States and third countries. Implementation of the latter may be postponed to 31 December 2021 if so opted by a Member State.

EFFECT ON DUTCH CV/BV STRUCTURES

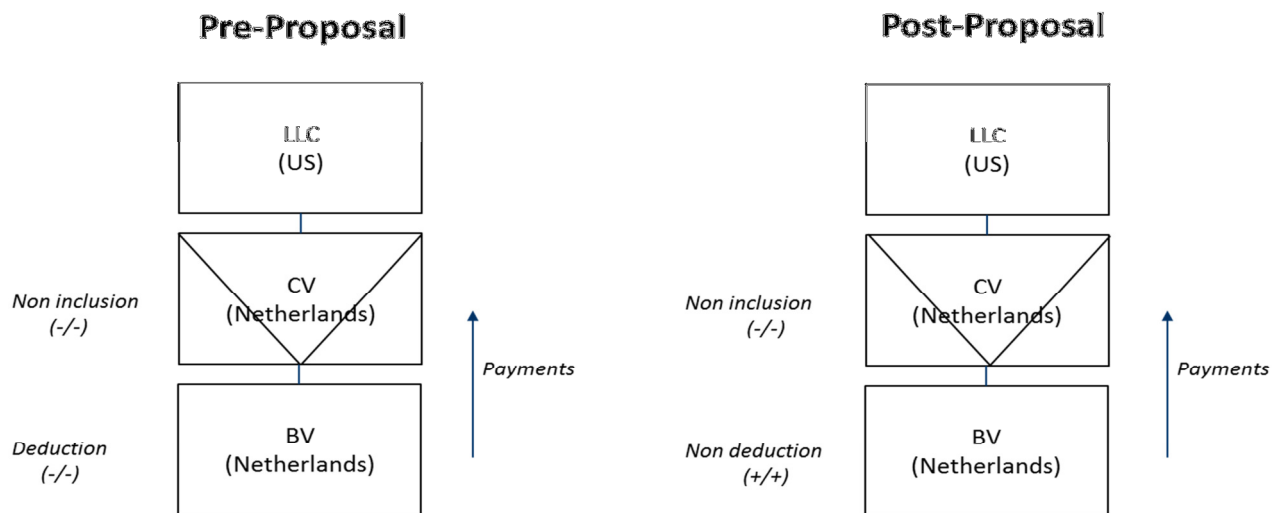
A hybrid mismatch-structure frequently used by US multinationals is a CV/BV structure. The CV/BV structure typically involves a Dutch limited partnership (CV) that owns the group's non-US IP and shares in a Dutch holding company (usually a BV or cooperative). The Dutch holding company, in turn, holds the group's non-US operating subsidiaries. Royalties and/or other fees are paid by the subsidiaries, via the Dutch holding company, to the CV.

The CV is set-up as a pass-through for Dutch tax purposes (and therefore not subject to Dutch corporate income tax). On the other hand, checking the box treats the CV as a corporation for US tax purposes, blocking the income from being taxable in the US. Accordingly, the payment of royalty/fee would effectively be tax deductible, without a corresponding inclusion of taxable income at CV-level.

Based on the rules of the ATAD 2, the above-mentioned mismatch would be neutralized by denying the deduction of the royalty/fee payment to the CV. As a result hereof, the CV/BV structure would no longer be effective.

EFFECT PROPOSAL ON CV-BV STRUCTURES

As a result of ATAD 2, the mismatch within the CV/BV structure would be neutralized. These rules state that in situations such as is the case with a CV/BV structure, the Netherlands as jurisdiction of the payer of the interest or royalty, should deny the deduction of the payment from the taxable base to the extent of the mismatch. For the CV/BV structure, this means that the BV may no longer deduct the interest or royalty payment from its taxable base.



IMPLEMENTATION

By broadening the scope of the current hybrid mismatch rules of the Anti-Tax Avoidance Directive, the EC intends to improve the effectiveness of the existing framework. As a result of ATAD 2, there will be a substantial impact for currently used CV/BV structures.

The ATAD 2 is to be implemented as of 31 December 2019 with the exception of the rules concerning CV/BV structures. Member States may opt to implement these rules concerning mismatches between Member States and third countries by 31 December 2021. The Dutch parliament has made a proposal where the Netherlands does not wish to make use of the postponed implementation date. Therefore, it is assumed that implementation of the rules concerning CV/BV structures will occur with effect from 31 December 2019.

THE NETHERLANDS

MULTILATERAL INSTRUMENT TO IMPLEMENT BEPS MEASURES INTO BILATERAL TAX TREATIES

On 24 November 2016, the Organization for Economic Co-operation and Development (OECD) released the text of the multilateral instrument. This instrument proposes to implement tax treaty related measures, developed by the OECD in its Action Plan against Base Erosion and Profit Shifting (BEPS), in one go into existing bilateral tax treaties. Unlike bilateral renegotiations, which could potentially take decades, the multilateral instrument aims to implement the BEPS measures as quickly and as efficiently as possible.

FRAMEWORK

The multilateral instrument is a key part of the OECD's effort toward implementation of tax treaty related BEPS measures. These measures include:

- (i) Action 2 on hybrid mismatch arrangements;
- (ii) Action 6 on treaty abuse;
- (iii) Action 7 on the artificial avoidance of the permanent establishment status; and
- (iv) Action 14 on dispute resolution.

The instrument intends to function alongside existing tax treaties. It will modify the application of existing tax treaties in order to implement the BEPS measures.

CONTENT

The instrument will consist of, on one hand, provisions that reflect treaty-related minimum standards and, on the other hand, provisions that do not reflect minimum standards.

The treaty-related minimum standards include the prevention of treaty abuse under action 6 and the improvement of dispute resolution under Action 14. Due to the large variety of options to satisfy the minimum requirements, the instrument provides enough flexibility to accommodate the positions of different countries.

The instrument also provides flexibility in relation to provisions that do not reflect minimum standards. This flexibility is reflected in, among other things, the allowance for countries to opt out of provisions or apply optional or alternative provisions. Also the instrument allows countries to specify the tax treaties to which the multilateral instrument applies.

PROCEDURE AND NEXT STEPS

Now that the text of the multilateral instrument has been released, the next step will be ratification which will take place in 2017 by the five countries involved in the development of the instrument.

For the specific tax treaties between countries, governments are currently preparing their lists of treaties to be covered by the multilateral instrument and are considering which options to select and reservations to make. Unilateral choices made by countries shall not enter into force until both parties to a specific tax treaty agree to the same options and reservations. Therefore, it is opted that countries notify the OECD of their considerations, who will then support governments in the process of its signature, ratification and implementation.

The multilateral instrument, as drafted by the OECD, is to be implemented after the ratification by five countries in 2017 and will apply for a specific tax treaty after all parties to that treaty have ratified the multilateral instrument.

IRELAND

NEW PERMANENT ESTABLISHMENT RULES

The concept of what constitutes a permanent establishment and ultimately whether there is a taxable presence, is an issue frequently faced by international organisations and tax practitioners alike. Unfortunately, there is no easy answer. Typically, interested parties will rely on the OECD commentary to article 5. While this is only commentary, it provides insight into the spirit and intention of what the model treaty intends to capture. Given that the vast majority of treaties negotiated by sophisticated jurisdictions tend to follow the OECD framework, this commentary can be persuasive. As part of the BEPS project, Action 7 considered the definition of what constitutes a permanent establishment. The recommendations and proposed changes have now been published. These will have a significant impact on what we theretofore have considered a permanent establishment and how organisations have been structured.

WHAT WILL CHANGE

The fundamentals of what will constitute a permanent establishment remain unchanged. A taxable presence will continue to arise if a company is carrying on a business through a fixed place of business.

There are two significant amendments proposed to the rule. The first being the operation of agents and commissionaire structures, while the second revolves around the scope of the permanent establishment exclusion rules. There is an optional anti-fragmentation rule that jurisdictions can sign up to which will further increase the risk of creating a permanent establishment.

AGENTS AND COMMISSIONAIRE ARRANGEMENTS

The current rules indicate that an agent will only create a PE where they habitually conclude contracts in the name of the enterprise, and the agent is not legally and economically independent from the principal. To manage this potential PE issue, typically organisations ensured that the signing of contracts was undertaken in the enterprise's home territory. Consequently, it was arguable that the sale was concluded in the home territory and taxable solely in that jurisdiction.

The proposed changes indicate that if the agent undertakes a significant portion of the work and no material changes are made in the home territory other than signing the contract, a PE could be considered to arise in the foreign jurisdiction. The new commentary also includes provisions to capture situations where the contracts are concluded in the agent's name, but using the principles IP or goods. The bar on what will constitute independence has been raised. Consideration will need to be given to whether the agent's business is largely or wholly dependent on business derived from the principal. If this is the position, the agent will no longer be considered independent.

PERMANENT ESTABLISHMENT EXCLUSION RULES

Current rules allow a blanket exclusion of certain operations such as warehouses, procurement offices or information collection. These scenarios are considered to be non-value adding and of a preparatory nature. Where an activity can be captured under one of these exemptions, the organisations are not considered to have permanent establishments.

The proposed changes will limit the scope of the exclusions. This is due to the extension of the "preparatory and ancillary test" from a section in its own right to cover the entire exceptions category. The proposed revised test is grounded in the concept that the activity must be of a short-term duration (preparatory), and not being an essential and significant part of the activity (ancillary). This is a significant limitation to the activities which will be able to avail of the PE exemption. The proposed new commentary gives an example of a distribution warehouse for an online retailer. Under the current rules, the warehouse would not be considered a permanent establishment as it typically falls within the scope of the exclusion contained in most tax treaties. However, under the new provisions, the

warehouse would be considered a permanent establishment as it is not considered to be temporary and that the distribution of said products would be perceived as essential to the business.

ANTI-FRAGMENTATION RULE

The optional anti-fragmentation rule permits a jurisdiction to group a number of operations in the same jurisdiction performed by closely related parties in order to determine that there is a permanent establishment. This is in order to combat the use of multiple subsidiaries in an endeavor to avoid a permanent establishment. However, this is limited to a certain extent by the inclusion of a clause requiring these complementary functions to be part of a cohesive business operation that is not of a preparatory or ancillary nature as described above. An extension of this rule covering timelines is also included to address the concerns of connected enterprises taking shorter contracts in succession to avoid creating permanent establishments. This requires groups to take a holistic view of their operations in any single country to ensure that they do not inadvertently create a PE.

WHEN DOES THIS COME INTO EFFECT

On 24 November 2016, the OECD published a Multilateral Instrument, through which countries are able to quickly implement the changes to bilateral treaties proposed by the BEPS project. The Instrument is open for signature with effect from 31 December 2016. A formal signing ceremony is planned to take place in Paris in June 2017. Following signature, individual signatory countries will need to ratify the terms of the Instrument in line with their domestic constitutional arrangements. The Instrument will be finalized and enter into force once it has been ratified by five jurisdictions. Following a period of three months, the Instrument will enter into force for those five jurisdictions at the start of the subsequent calendar month. The same three month period will apply for all other jurisdictions that subsequently ratify it. Assuming that all goes to plan, the changes could come into effect from 1 January 2018.

103 jurisdictions participated in the BEPS project. If implemented, the Instrument could result in more than 2,000 treaties being amended. This would equate to more than two thirds of the world's double taxation agreements. While the proposed changes have the potential for significant change, it would be preferable if there was widespread adoption. At least if this were to occur, it would ensure consistency and certainty for businesses and tax authorities.

LUXEMBOURG

On 27 December 2016, a new Circular (L.I.R: nr 56/1 – 56bis/1, “Circular”) supervising the fiscal treatment of intra-group financial transactions was incorporated in the Luxembourg Income Tax Law and is effective from 1 January 2017. It replaces the circulars L.I.R. nr 164/2 of 28 January 2011 and L.I.R. 164/bis of 8 April 2011.

With this new regulation, the OECD guidelines concerning the application of the “arm’s length” principle in the context of intra group financing activities are transposed in the Luxembourg law.

These changes have many consequences, among them, the transfer pricing reports supporting the spread need to be amended in order to reflect the new instructions of the Circular. All existing advance pricing agreements previously granted will no longer be binding on the Luxembourg tax authorities with effect from 1 January 2017.

The European Court of Justice (“ECJ”) is going to statute on the relation between the Member States restrictions on dividends payments and the scope of the Parent-Subsidiary Directive, as well as the freedom of establishment granted by treaties. The position taken by the advocate general confirms the interest of Luxembourg companies in the structure of participations chain.

NEW TRANSFER PRICING CIRCULAR FOR FINANCING ACTIVITIES

Luxembourg has recently modernized its legal framework to take into consideration the latest OECD developments in term of transfer pricing. The published Circular has an impact on how to prepare the transfer pricing documentation related to intra-group financing activities, as well as APA’s in respect of intra-group financing activities.

MAIN CHANGES UNDER THE CIRCULAR

Comparability analysis

The Circular emphasizes the fact that the comparability analysis mentioned at paragraph 4 of article 56bis L.I.R. is composed of two mandatory steps:

- First, the identification of the commercial and financial relations between the associated companies, as well as economic circumstances of these relations.
- Second, the comparison of the conditions and the economic framework of the transaction with similar open market transactions.

Economic reality over the contractual terms

The economic reality of the transaction prevails over the contract. The tax authorities will search the real intention of the parties to determine the objective of the operation. If the transactions lack of commercial rationale and would not be performed with third parties under the same conditions, they should be disregarded.

Functional analysis

In the context of the transaction, the functional analysis enables identification of the different functions performed by the parties, such as the initiation of the transaction and its management, as well as the assets used and the risks assumed.

Safe Harbour for equity

Safe Harbour for equity level and a Safe Harbour for return on equity are distinguished.

The first analyses the capacity to manage and to assume the risk. It foresees that when the intra group financing entity has the same profile, that the entities submitted to the European regulation (EU) n°575/2013 of European Parliament and Council dated 26 June 2013 on the prudential requirements applicable to the credit establishments and to the investment companies (hereinafter "European regulation"), and has an amount of equity respecting the rules imposed by this European regulation on solvency, the equity level is considered to be enough high to avoid financial problems if any risk raises.

The Safe Harbour for return on equity determines the arm's length compensation, and in the case of companies which are similar in their function as the entities submitted to the European regulation, a percentage of return on equity of 10% after tax may be considered as respecting the arm's length compensation.

This percentage will be reviewed annually by the tax authorities. .

The minimum required capital at risk of 1% of the financing amount (limited at EUR 2 million) is no longer applicable.

Substance requirements

The Circular provides that in order to be able to control the risks, the company performing the intra-group financing transactions should have a decision-making capacity. As such, it should comply with the following substance requirements:

- The majority of board members or managers who have the power to engage the company should be Luxembourg residents or non-residents with at least 50% of professional income taxable in Luxembourg. Board members being legal persons must have the legal office and central administration in Luxembourg.
- The company should have skilled employees to control the transactions, while the supporting functions can be outsourced. Crucial decisions and at least one general meeting per year must take place in Luxembourg.
- The entity must not be considered a tax resident of a foreign jurisdiction.

Simplified measures for intermediary entities

If the financing entity has only an intermediary activity and satisfies the substance criteria, the return after tax of at least 2% is considered as arm's length compensation. It is presumed that in such case, the development of a transfer pricing report is not mandatory.

The application of a different rate can be exceptionally accepted only on the basis of a Transfer Pricing report.

The obligation of a transfer pricing report for an Advance Pricing Agreement request

The future requests for an Advance Pricing Agreement must be followed by a transfer pricing report and a number of minimum information listed in the point 32 of the Circular.

ACTION POINTS

We recommend the companies applying the transfer pricing circular of 2011 in respect to financing activity, to consider the following questions:

- How does the Circular impact the structure?

- Is your current level of substance in line with the provisions of the new Circular?
- What will be the new level of equity required be in order to adequately cover the risk of your financing activity?



LUXEMBOURG

ANTI-ABUSE RULES – EU DIVIDEND PAYMENTS

The Parent-Subsidiary Directive provides that profits which a subsidiary established in one EU Member State distributes to its parent company established in another EU Member State, shall be exempt from withholding tax, under specific conditions.

Article 1(2) of the Directive also provides that the directive shall not preclude the application of domestic provisions required for the prevention of fraud or abuse.

The 2016 ECJ case of *Egiom SAS, previously Holcim France SAS (C-6/16)* considers the restrictions on the exemption from withholding tax implemented by France. The opinion of the Advocate General presented on 19 January 2017 has a positive outcome for Luxembourg companies often used in international structuring.

BACKGROUND

The case concerns a French company which distributed dividends in 2005 and 2006 to its 100% parent company, a Luxembourg resident entity. At the time, almost all shares of the Luxembourg parent company were owned by a company resident in Cyprus, which was in turn was controlled by a company resident in Switzerland.

The French tax authorities denied the withholding tax exemption on payment of the dividends by the French subsidiary to its Luxembourg parent. This was based on article 119b(3) of the General Tax Code of France (the “CGI”), which provides that such exemption does not apply where the distributed dividends are for the benefit of a legal person controlled directly or indirectly by one or more residents of States that are not members of the Union, unless that legal person provides proof that the principal purpose or one of the principal purposes of the chain of interests is not to take advantage of the exemption. The Luxembourg beneficiary was unable to prove that the business structure of the group and the chain of participations had a commercial reason and was not only created for tax advantages.

The questions referred to the Court seek to clarify whether this restrictive rule is in line with the Parent-Subsidiary Directive and the fundamental freedoms granted by the treaties.

CONCLUSIONS OF ADVOCATE GENERAL

Under French law, the fact that the Luxembourg company receiving the dividends was directly or indirectly controlled by persons not resident in the EU gave rise to the presumption of an abuse.

The Advocate General considered the measure disproportionate and not permissible under Article 1(2) of the Parent-Subsidiary Directive. This is on the basis that proof of non-fiscal grounds was automatically imposed on the Luxembourg company without the administration being obliged to provide sufficient indications of tax evasion. As such, the refusal to grant an exemption must be justified by evidence and not based on a general presumption that a distribution will involve tax evasion.

Furthermore, it was concluded that the freedom of establishment of the Luxembourg company was restricted since only distributions of profits to non-resident companies are subject to the special proof requirements under article 119b(3) and not dividend payments to resident companies.

AN ATTENUATION OF THE RESTRICTIVE RULES OF BEPS AND THE EUROPEAN COMMISSION BENEFICIAL FOR LUXEMBOURG COMPANIES

If the Court follows the conclusion of the Advocate General, this decision would benefit the non-EU resident beneficiaries of dividends distributed by the EU subsidiaries.

The burden of proof would be reversed to the tax authorities and this would benefit the Luxembourg entities which are appreciated for their tax treatment on participations and their place in the chain participations structure.

The ECJ would limit the extension of restrictive measures initiated by the OECD with BEPS rules and by the European Commission on the profits arising from participations. The qualification of a company as an “*artificial entity*” always mentioned by these institutions would be more difficult to sustain and so the pressure on companies by the tax authorities on that ground may be attenuated.

HERE TO HELP YOU!



The members of the US Desk are here to help you!

If you have clients looking at establishing in Europe, or indeed who have existing European operations, we are here to provide you with answers.

Desk members can serve as a single point of contact for you. We can liaise with other European offices and introduce you to the right people.

The contact details for Desk members are enclosed. We can also be found at <https://www.linkedin.com/groups/8356656>

FISCAL IMPACT OF SELLING SHARES IN A LIMITED LIABILITY COMPANY (“GMBH”) AT A DISCOUNT TO THE GMBH ITSELF

In its judgement of 20 January 2016, AZ. II R 40/14, the Federal Court of Finance had to decide whether the sale of a substantial interest to the same company constitutes a hidden equity contribution (§ 6 Abs. 6 S. 2 EStG and § 17 Abs. 1 S. 2 EStG) or a taxable donation (§ 7 Abs. 1 or 7 ErbStG).

BACKGROUND

Two spouses were the sole shareholders of the GmbH. One of the spouses left the company in 2004 by transferring his shares to the company at a value significantly below the market value. The tax authority issued a gift tax assessment, because it qualified such a transfer as a donation according to § 7 Abs. 7 ErbStG amounting to the difference between the market value and the lower purchase price. The Federal Court of Finance decided that such a sale of shares to the company under the market value constitutes a hidden equity contribution, which excludes a taxable donation.

THE RULING

A transfer of assets from the shareholders to the company in the course of their corporate relationship serves the corporate purpose. Therefore, such a transfer of assets must be qualified as a process under corporate law and not as a generous gift to the shareholders.


Although the shareholder in the case at hand left the company as a result of selling his shares – and therefore cannot benefit from the promotion of the corporate purpose – the assumption of a donation is not principally excluded. In this case the assumption of a donation was excluded because the sale of shares to the company under the market value constitutes a hidden equity contribution of the share according to § 17 Abs. 1 S. 2 EStG. A hidden equity contribution cannot be qualified as a purchase by generous donation at the same time.

The Federal Court of Finance did not discuss the consequences of this decision in regard to income taxes. As a rule, the hidden equity contribution of a share is deemed to be a sale of the share due to the legal fiction in § 17 Abs. 1 S. 2 EStG. The fair value of the hidden equity contribution constitutes additional acquisition costs for the contributing shareholder (§ 6 Abs. 6 S. 2 EStG). The shareholder has to pay taxes on this fictive capital gain.

What is new is that the hidden equity contribution is attributed to the remaining shareholder and not to the withdrawing/contributing shareholder. The impact of this decision on income taxes, as well as its statutory basis, was not clarified by the Court.

IMPLICATIONS

Transfers of shares to the GmbH at a purchase price significantly lower than the market value constitute hidden equity contributions, when the contribution by a shareholder (or a person closely associated with him) to the company takes place without an appropriate compensation by reasons of the corporate relationship. The regulation of § 7 Abs. 8 ErbStG, which was introduced into the law only after this dispute, was not applicable to the case and



therefore not taken into account by the Court. Given the argumentation of the Court, the future application of § 7 Abs. 8 ErbStG should have no impact on the decision.

It is not clear whether this decision of the Federal Court of Finance has a positive effect for the taxpayer or whether the arising income tax will be higher than the gift tax. The income tax consequences are not clarified by this decision. Another proceeding concerning this matter is pending before the Fiscal Court Köln (Az. 15 K 2664/11).

UNITED KINGDOM

INVESTING IN THE UK – POST BREXIT

On 29 March 2017, the two year process was triggered for the UK's exit from the EU. Whatever deal or transitional arrangement is made, by the end of March 2019 the UK will leave the EU ending over forty years of membership of the single market. At the same time, the UK is implementing measures to implement the OECD recommendations which formed part of their 15 point BEPS action plan.

At this time of uncertainty in the tax landscape, there are some things we do know in the context of US investment into the UK despite the UK's future relationship with the EU being uncertain.

LOW RATE OF CORPORATION TAX, ATTRACTIVE R&D & PATENT BOX REGIMES

The UK headline rate of corporation tax will fall to 17% by 2020 and with R&D tax deductions and Patent Box reliefs; the effective rate can fall below 10% for some tech and pharma businesses. There have been suggestions that the headline rate of corporate tax may reduce further to 15% in the future. Whilst the headline rate is comparatively low and the UK has attractive IP regimes, the UK also has rather comprehensive anti-avoidance legislation which is intended to ensure all relevant UK profits are brought into charge.

ATTRACTIVE WITHHOLDING TAX REGIME AND TAX TREATY NETWORK

The UK does not levy withholding taxes on dividends. Its treaty with the US generally allows the payment of royalties and interest gross (although in the case of interest, clearance must first be obtained from HMRC). The UK has an extensive network of Treaties with other jurisdictions which will not be affected by Brexit. Unlike the benefit conferred by EU Directives, not all Treaties provide for a zero rate of withholding. For example, the Italian Treaty allows a reduction to 8% and Luxembourg to 5% although reductions such as this mean full relief by credit against UK tax should usually be obtained.


PERMANENT ESTABLISHMENT & DIVERTED PROFITS TAX

HMRC have in practice been applying the lower OECD BEPS threshold for dependant agent PEs for some time. This means HMRC usually regard a PE as being created by dependant agents (such as employees and certain contractors) who habitually exercise an authority in the UK to substantially negotiate the terms a contract on behalf of another entity. This is the case even if the agent itself does not sign the contract. This brings an attribution of the profits from that contract within the charge to UK tax.

In 2015, the UK introduced a 25% "Diverted Profits Tax" which falls outside of tax treaty protections raising the prospect of double taxation for effected profits. The tax applies to "Avoided PEs" and "Transactions lacking in economic substance" more generally. The government's expectation is not to be collecting the 25% tax but rather see companies to declaring, for example, a UK PE and pay mainstream UK corporation tax.

FINANCING INVESTMENT INTO THE UK

As reported in an earlier Newsletter, following on from the OECD BEPS Action 4, the UK is introducing a new cap on interest tax deductions. This will have effect from 1 April 2017 and applies after the transfer pricing analysis. The proposals broadly limit a UK group's allowable net interest expense to 30% of a form of tax adjusted EBITDA with an overarching limit based on the worldwide group's consolidated net interest expense.



A de-minimis net interest expense of £2m applies and so whilst initial seed investment may not be effected, future investment may require further planning. Whilst there is a Public Benefit Project Exemption in relation to qualifying infrastructure projects this is not always beneficial.

In the context of structuring investments UK legislation was enacted in 2016 to tackle hybrid financial instruments and structures (those seeking to exploit tax arbitrage) in line with BEPS Action 2. Whilst, as previously reported, the EU is regulating to ensure all member states implement rules to prevent hybrid mismatches the UK has already established its position and this is unlikely to change post Brexit.

TAX TRANSPARENCY

Large UK companies (broadly those with a turnover over £200m or assets > £2bn) and part of groups within Country by Country Reporting (“CbCr”), must publish their tax strategies online. The first CbCr is due at the end of 2017 for December 2016 year ends. HMRC must be notified if a CbCr is being filed in a different jurisdiction which has signed up to exchange of information with the UK.

In April 2016 the EU Commission put forward a proposal for public CbCr. This would require any multinational group active in the EU’s single market, with a permanent presence in the Union and a consolidated turnover in excess of €750m to publish certain financial information on their website. The current status of these proposals has not been published and nor has the UK’s position in this respect post Brexit.

UK STATUS WITH THE EU POST BREXIT

The UK has often been used by US companies as a bridge into Europe. Now the UK is beginning negotiations to exit the EU, the nature of the UK’s future relationship with the block will gradually become clearer. In the meantime there is uncertainty on how customs duties and VAT will apply in particular to UK trade with the EU and this is key to the “comprehensive free trade deal” the UK is seeking to negotiate.

In leaving the jurisdiction of the EU Commission, the UK will be free however of the type of State Aid considerations in taxation policy which have been highlighted in the Apple, McDonalds and Starbucks EU cases. The UK may therefore seek to adopt fiscal policies to soften any Brexit impact on business and maintain the UK’s competitiveness.

Whilst much is uncertain around the UK’s post Brexit status with the EU, in the context of BEPS we should expect future fiscal incentives to remain in line with BEPS action point principles. This means we can expect any beneficial tax regimes to be underpinned by the substance of activities undertaken in the UK.

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