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International Tax Cooperation

UK Sets Out Its Priorities for the OECD Base Erosion and Profit Shifting (BEPS) Project

SUMMARY

The UK government has published a paper setting out in detail its position on the OECD's Action Plan on Base Erosion and Profit Shifting.

Distinct from the general discussion surrounding the wide-reaching aims of the BEPS project, the 19 March paper gives helpful detail on the main points of interest from a UK perspective.

The UK's approach can be summarised as follows:

- support for the BEPS project in general;
- support for many of the Action Plan's specific proposals;
- a belief that the UK offers models for what can be done in several areas, coupled in some cases with a reluctance to go beyond what the UK has already done;
- concern that measures to counteract BEPS should be proportionate, bearing in mind:
  - the sovereignty of taxing jurisdictions; and
  - the potential costs to government and business of some proposals; and
- sensitivity as to the impact on the UK's financial sector and investment in UK infrastructure.

BACKGROUND

The OECD Action Plan on BEPS published on 19 July 2013[1] sets out 15 points for action to strengthen international cooperation on countering tax avoidance. The 15 action points overlap in a number of areas[2].

The action points cover the following key aims:

- to increase transparency and to develop cohesive multilateral information disclosure so tax authorities can identify and assess risk (e.g. country-by-country reporting in respect of multinational entities; standardised transfer pricing documentation requirements; an international system for disclosure of tax avoidance schemes);
- to reduce opportunities for aggressive tax planning (e.g. by abuse of double taxation treaties; by taking advantage of mismatched treatment of instruments and entities among taxing jurisdictions; by manipulating transfer pricing rules); and
- to assess the proper way to tax the growing digital economy (e.g. where online businesses have the ability to operate in a jurisdiction without any significant physical presence in that jurisdiction).

The UK government endorsed the 15-point BEPS Action Plan in September 2013. On 19 March 2014, as part of the UK Budget, the UK government published a paper setting out its position on various points in the BEPS Action Plan.

The 19 March paper gives details of the UK's priorities and particular concerns for the BEPS project. The paper focuses on how implementation of the Action Plan may interact with aspects of UK law, and gives examples of measures already enacted in the UK to counter base erosion and profit shifting, such as the UK's CFC (controlled foreign company) rules and its ever-expanding tax shelter disclosure rules.

AREAS OF FOCUS OF 19 MARCH PAPER

A. UK SUPPORT FOR PROPOSALS UNDER CONSIDERATION

On many of the action points, the UK pledges support for proposals that will result from discussion and consultation among the member states of the OECD and the G20. The UK belongs to both groupings.

Permanent establishments

The UK is in favour of a re-examination of what constitutes a "permanent establishment" (Action 7) to take account of modern business models such as online trading, including whether warehousing (traditionally seen as a preparatory or auxiliary act and therefore not a permanent establishment) should of itself constitute a permanent establishment in certain cases.

Transfer pricing rules

The UK also supports changes to the transfer pricing rules to ensure that they reflect a multinational group's internal allocations of functions, risks and assets (Actions 8-10). The UK transfer pricing rules are based on the current international standard. However, this standard may allow groups to argue that excessive risk, capital and intangible assets are legitimately located in low-tax jurisdictions. The UK recognises that transfer pricing methodologies may need modification to ensure that aggressive tax planning and over-allocation of capital and intangibles to low-tax jurisdictions is effectively addressed.

Areas of international cooperation and dispute resolution

To cement the efficacy of international action against BEPS, and to expedite the necessary changes, the UK supports the introduction of a multilateral instrument (Action 15). The UK is also in favour of extending binding arbitration in cases of dispute at an international level to minimise the risk of double taxation, e.g. in transfer pricing disputes (Action 14).

B. UK MODELS FOR ANTI-AVOIDANCE MEASURES

The UK tax system already contains a number of measures that seek to counteract BEPS. The paper suggests that some of these could be models for international cooperation.

Controlled foreign company (CFC) rules

The UK is actively contributing to the discussions on the action point of strengthening CFC rules (Action 3) in light of its recent experience of reforming the UK CFC regime. The reformed regime is now more focused on the artificial diversion of profits away from the UK[3]. These reforms are perceived to have made the UK CFC rules less restrictive. The UK does not plan to revisit them in the light of the BEPS project.

Restricting interest deductions

The UK has a well-developed approach to countering base erosion via interest deductions (Action 4). In particular, interest deductions are disallowed where a company is party to a debt instrument with a “main purpose” of tax avoidance, or to the extent that a debtor entity is “thinly capitalised” (i.e. has higher levels of debt than would be lent to it on arm’s length terms). Moreover, the UK worldwide debt cap operates to disallow interest and other deductions where a group has excessive levels of debt attributable to its UK members (the debt cap is prima facie triggered where “UK net debt” of UK-taxpaying group members is more than 75% of that group’s “worldwide gross debt” on a consolidated basis). The special issues regarding the taxation of financial services and the worldwide debt cap have already been mentioned.

Disclosure of Tax Avoidance Schemes (DOTAS)

The UK DOTAS rules are under consideration by the relevant BEPS working group as a model for rapid, “real time” disclosure of aggressive tax-planning arrangements (Action 12). DOTAS has been greatly expanded since its introduction in 2004. In particular, it requires persons who promote or introduce taxpayers to tax avoidance schemes in certain prescribed areas, and sometimes users of such schemes, to provide HM Revenue & Customs with advance information about those schemes. The UK government has used such information to investigate schemes, and often to legislate rapidly to close them down. The paper suggests that mandatory disclosure rules such as those under DOTAS could usefully be applied in respect of hybrid mismatches; transactions undertaken to abuse treaty provisions; and transactions falling within any future transfer pricing anti-abuse rules.

VAT place of supply rules

The paper also notes that the UK has been "at the forefront" of changes to the VAT place of supply rules. These changes mean that VAT is levied where the recipient of cross-border supplies of goods or services is located, rather than where the supplier is located. This is one element of reform designed to tax the digital economy more effectively (Action 1) by discouraging establishment of digital businesses in jurisdictions with lower VAT rates in order to avoid higher VAT rates in the jurisdictions where their customers are located.

Anti-treaty abuse rules

The UK has around 120 double taxation agreements (tax treaties) with other countries and territories, and has, for some time, included provisions denying treaty benefits where taxpayers have "a main purpose" of taking advantage of a treaty's provisions. The OECD is considering this purpose-based model to counter treaty abuse. It is also considering the "limitation of benefits" model familiar in US tax treaties, whereby treaty benefits are available only to limited classes of persons, defined in such a way as to limit the scope for abuse. The US-UK and the Japan-UK treaties both have limitation of benefits provisions, although UK treaties typically follow the purpose-based model, which the UK prefers as more flexible in terms of combating avoidance.

C. PROPORTIONALITY OF BEPS COUNTERMEASURES

Proportionality at national level

The UK government is keen to ensure that measures to combat BEPS are weighed against the sovereign rights of taxing jurisdictions to structure their tax systems to attract investment. The paper reaffirms the UK's aims of implementing proposals arising out of the BEPS project while remaining a competitive economy in an international environment.

The UK government has pledged to assess any policy options against its requirements of proportionality, consistency and certainty; the stability and sustainability of UK tax revenues; the competitiveness and operational efficiency of the UK tax system; and a proportionate compliance burden on governments. The UK must also take into account principles of EU law and the fundamental "freedoms" enshrined therein, which necessarily place constraints on measures to counteract BEPS. However, recent decisions on the compliance of corporate "exit charges" with EU law suggest that the Court of Justice of the European Union is willing to countenance restrictions on fundamental freedoms where they are consistent with the aim of achieving a balanced allocation of taxing rights between Member States and/or tackling tax avoidance[4].

In respect of the action point on tacking "harmful tax practices" (Action 5), the UK warns that any countermeasures should be balanced with the rights of countries to design and use genuine incentives for economic growth. However, the UK does support a focus on jurisdictions where informal ruling procedures (often with little transparency) give rise to preferential tax regimes, in contrast to generallyavailable targeted reliefs such as the UK "patent box" which provides for a preferential 10% rate of corporation tax on certain profits arising from qualifying intellectual property[5]. The paper also notes that clarity is needed on what level of "substantial" activity is required to take place in jurisdictions with preferential regimes, if harmful tax practices are to be avoided.

Proportionality at entity level

The UK is keen to ensure that businesses are not overburdened by measures to combat BEPS. For example, the UK recognises that transfer pricing documentation should be more readily available to taxing authorities so risks can be assessed in real time rather than waiting for an audit to be opened (Action 13). However, the UK envisages that companies should only be required to provide data collected "in the normal course of business" to the taxing authorities in the jurisdictions in which they operate. The compliance burden on companies should be proportionate to the need to provide useful information to taxing authorities.

D. AVOIDING ADVERSE EFFECTS ON THE FINANCIAL SERVICES SECTOR, AND OTHER ECONOMIC SECTORS

The UK government recognises that the financial services sector requires particular consideration in assessing the viability of any BEPS proposals.

One of the key areas in which implementation of measures is envisaged before the end of 2014 is "hybrid mismatches", i.e. the ability of taxpayers to take advantage of different treatment of entities and instruments as between different taxing jurisdictions (Action 2). A classic example of such a mismatch would be an instrument that is treated as debt in the jurisdiction of the debtor (thereby allowing the debtor to obtain a deduction on account of interest payable), and treated as equity in the jurisdiction of the creditor (therefore not giving rise to fully taxable income for the creditor).

The paper suggests that hybrid mismatches be neutralised by cooperative cross-border measures, possibly using a two-step approach that would, in the example above, deny a deduction to the debtor or, if that were not possible, force the creditor to book a fully taxable receipt.

However, the paper recognises that hybrid instruments are created in certain non-tax-motivated circumstances, e.g. under the regulatory capital rules for financial institutions (Basel III and the Capital Requirements Directive IV for banks and building societies, and the equivalent EU Solvency II Directive for insurers). The UK is keen that any anti-mismatch rules do not disincentivise financial institutions from raising capital in loss-absorbent forms, in order to meet required regulatory standards. The UK has enacted rules to facilitate the tax-efficient issue of such regulatory capital instruments by banks[6] and building societies operating in the UK. It proposes to do the same for insurers affected by the EU Solvency II Directive. In 2005, the UK enacted legislation which seeks to curb certain tax-motivated transactions based on hybrid instruments or entities. However, to date, the UK has sought to apply those rules so as not to impede UK financial institutions from issuing tax-efficient regulatory capital instruments.

In respect of the action point on base erosion using interest deductions (Action 4), the paper again highlights the need to consider the position of financial institutions, for whom servicing debt is a core trading expense. The UK government is firm that it would not be appropriate to put in place any structural model restricting interest deductions in respect of the financial sector, and "certainly not in respect of [financial institutions'] day-to-day activities". In this respect, the UK is drawing on its own experience in creating (in 2009) and applying "worldwide debt cap" legislation which can in some cases limit the ability of a multinational group to claim UK tax deductions for the financing expenses of its UK-taxpaying members: financial services groups are usually excluded.

The paper also recognises the need to carve out of any general restriction on interest deductions the infrastructure investment sector, in which using highly indebted SPVs is standard commercial practice.

NEXT STEPS

The target implementation dates for the steps in the Action Plan are ambitious. For example, action on hybrid mismatches, taxing the digital economy, treaty abuse and country-by-country reporting and transfer pricing information is envisaged by the end of 2014, and action on the remainder of the points is to be implemented by the end of 2015.

Given the complex nature of the topics under discussion, and the number of diverse taxing systems involved, it seems unlikely that the BEPS project will be complete in its entirety by the end of 2015.

The paper of 19 March highlights the UK's commitment to the BEPS project. The UK has a wealth of relevant experience in countermeasures. It is seeking to share this experience in active discussions and recommendations to the BEPS working groups in formulating key proposals, while taking into account issues of particular concern for the UK economy.

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ENDNOTES

1 Available at http://www.oecd.org/ctp/beps.htm.

2 For further detail, see our memorandum of 20 August 2013, available at http://www.sullcrom.com/International-Tax-Cooperation.

3 See our memorandum of 5 January 2012, available at http://www.sullcrom.com/UK-Controlled-Foreign-Company-Reform-01-05-2012.

4 For example, *National Grid Indus* (C-371/10) and *Commission* v. *Portugal* (C-38/10).

5 The EU Code of Conduct group is tasked with assessing all patent boxes in the EU by the end of 2014, to ensure they are compliant with EU law and consistent with the principle of equal treatment.

6 See our memorandum of 6 January 2014, available at http://www.sullcrom.com/Regulatory-Capital-Requirements-01-06-2014.

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