

# Tax Newsletter: KPMG Isle of Man

## Issue 49

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We hope you will enjoy this issue of our Tax Newsletter. Our purpose is to try and keep you abreast of topical UK tax issues which may affect you, your business, and/or your clients.

### UK Autumn Budget 2018

Whilst many of the measures announced at the Autumn Budget were largely expected (such as the reform of the corporate intangibles regime), others were more of a surprise (for example, the various capital allowances announcements). The headline news for international tax was the announcement of a UK Digital Services Tax, which will be levied on 'tech giants' with global revenues of at least £500 million – [the consultation](#) on the detailed design and implementation of this tax was published on 7 November 2018.

Changes to the 'IR 35' rules for the private sector, which shift responsibility for compliance with off-payroll working rules from individuals to the organisation paying them, have been delayed until April 2020, which will be positively received by business.

There was also evidence of the impact of Brexit, with the Budget setting out a power to allow the Government to make 'minor' amendments to tax legislation in a 'no-deal' Brexit scenario. Another full fiscal event in the spring has not been ruled out, likely depending on Brexit negotiation outcomes.

We have summarised below the main areas of interest from an Isle of Man perspective.

The Finance (No. 3) Bill 2017-19 was published on 7 November 2018. This bill will become Finance Act 2019 once it has completed its path through Parliament.

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### *Land and property owned by non-UK residents*

Currently, UK residential property held by non-UK residents is within the scope of a narrowly-focused charge to CGT. The Government has confirmed it will introduce plans, originally announced in Autumn Budget 2017, to extend from April 2019 the scope of this tax charge to include all UK immovable property, including commercial property and other UK land. A return and payment on account will be required within 30 days following the completion of the sale. The change will affect all non-UK resident property investors (whether individuals, companies or other entities), with only limited proposed exemptions. Changes will also be introduced to levy the charge to CGT on disposals of entities which derive their value from UK property, along with targeted anti-forestalling rules which came into effect from 22 November 2017. These changes are a significant expansion of the current CGT rules for the property sector, where a significant portion of investment comes from outside the UK.

In addition the Government confirmed that as previously announced, from April 2020, new rules will be introduced to move non-resident corporate landlords from income tax to corporation tax.

For non-UK residents acquiring UK residential property the Government is to consult on the introduction of a surcharge in addition to existing Stamp Duty Land Tax (SDLT). The Budget documents confirm that the amount of the surcharge will be 1%; however, no further details, such as when the new rate will be introduced or what tests will be used to determine residency, have been released.

The levy will likely apply in addition to the current 3% surcharge that applies to purchases of 'additional' dwellings by individuals and purchases of dwellings by companies. Accordingly, where a foreign buyer already holds a dwelling anywhere in the world, they will face paying a total SDLT surcharge or levy of 4% on top of the tax payable in accordance with the standard rates.

An overseas buyers levy exists in a number of countries around the world, notably Canada. Taking into account the total amount of tax payable on the purchase, ownership and sale of residential property, the tax regime in England and Northern Ireland (the only countries so far affected by the proposed change) compares surprisingly well to equivalent overseas tax regimes. A levy of 1% on the purchase of dwellings will not change that. Until today the levy was expected to be between 1% and 3%. The levy is expected to fund efforts to reduce homelessness. The above measures represent further significant but targeted changes to the general regime taxing UK land and property holdings.

### *Changes to the definition of permanent establishment*

Under UK domestic law, a non-resident company is generally only subject to UK tax where it is trading in the UK, either under the corporation tax regime (if such trade is carried out through a permanent establishment (PE) as defined under domestic law) or otherwise through the income tax provisions.

However, where there is an applicable double taxation agreement a non-resident company trading in the UK is generally liable to UK corporation tax only if it has a PE in the UK, typically through a fixed place of business or a dependent agent. Certain preparatory or auxiliary activities, such as storing the company's own products, purchasing goods, or collecting information for the non-resident company, are however specifically

excluded from the definition of PE under domestic law and most tax treaties.

Under [BEPS Action 7](#), the OECD proposed an anti-fragmentation rule to address the fragmentation of activities between closely related parties in order to artificially avoid creating a PE. The UK has chosen to apply this provision through its ratification of the OECD's Multilateral Convention (MLI), which is due to enter into force in 2019. The Government will legislate in Finance Bill 2018-19 to give full effect to this treaty change by updating the domestic law definition of PE to ensure treaties impacted by the MLI are subject to corporation tax rather than income tax, making the MLI changes fully effective.

This measure will therefore primarily impact multinationals resident in treaty jurisdictions with a presence currently exempt through the preparatory or auxiliary exemption under the terms of a double taxation agreement. If no double taxation agreement applies then, to the extent a non-resident is trading in the UK, such activities should remain taxable through the income tax regime even if no PE is established under the revised provisions.

### *Tax avoidance involving profit fragmentation*

As previously announced, the Government is introducing [targeted anti-avoidance legislation](#) which aims to prevent UK businesses from avoiding UK tax by arranging for their UK-taxable business profits to accrue to entities without sufficient substance and resident in territories where significantly lower tax is paid than in the UK. Included in the Budget following consultation, changes have been made to the draft legislation to remove the duty to notify HMRC of relevant arrangements meeting certain criteria. The rules will commence with effect from April 2019 and will apply to an individual or a company carrying on a business within the charge to UK taxation, including in partnership.

### *CGT Entrepreneurs' Relief*

The Budget introduced changes to CGT Entrepreneurs' Relief (ER) that will impact shareholders and business owners. This is likely to particularly affect management teams in private equity backed businesses who often hold small shareholdings and currently expect to qualify for ER. This change will also impact many employee shareholders, particularly in a private equity context, who may no longer qualify for ER.

- With effect from 29 October 2018, a shareholder will only qualify for ER where they have a shareholding with the characteristics of true entrepreneurial activity. In practice, this means that shares that have limited economic rights to dividends or entitlement to capital on a sale or winding up are unlikely to qualify.
- In addition, the minimum qualifying period for which an asset has to be held to qualify for relief has been increased from 12 to 24 months which will take effect for disposals on or after 6 April 2019.
- a de minimis UK sales threshold of £10 million;
- an exemption for partnerships which are regarded as separate entities for tax purposes and resident in full treaty territories;
- an exemption for income that is taxed at an effective rate of at least 50 percent of the rate that would otherwise arise under this measure; and
- an exemption for income relating to intangible property that is supported by sufficient local substance and which has not been acquired from related parties.

The Government has confirmed that legislation will be introduced from 6 April 2019 which allows individuals who are diluted below 5 percent following a fund raising after 6 April 2019 to elect for their ER to be crystallised at the time of share issue. There will also be an election allowing the individual to defer any tax due until a future liquidity event.

### *Relief for transactions involving intangible assets*

Following the [2017 consultation](#) on introducing an expanded royalty withholding tax, the Government has announced the introduction of a measure that directly taxes certain offshore entities holding intangible property in low tax jurisdictions where income arises in relation to that intangible property directly or indirectly from the sale of goods or services in the UK.

The measure will apply regardless of whether there is a UK taxable presence, and will apply to gross income received (including embedded royalties and income from the indirect exploitation of intangible property) with effect from 6 April 2019.

The measure will apply in both connected and unconnected party scenarios, but will only apply where the ultimate recipient is in a low tax jurisdiction.

Low tax jurisdictions for these purposes are regarded as being those jurisdictions with which the UK does not have a double tax agreement that contains a non-discrimination provision. Any person within the same control group during the relevant tax year will be jointly and severally liable for the new tax.

In order to ensure the measure is appropriately targeted, the Government will also legislate the following exemptions:

Multinationals should also be mindful of the targeted anti-avoidance rule introduced by this measure, with effect from 29 October 2018. This targeted anti-avoidance rule will counteract arrangements that are entered into with a main purpose of avoiding a charge under this new measure.

### *CGT Private Residence Relief*

Effective from April 2020, the Government plans to restrict two ancillary parts to Private Residence Relief (PRR). The first part is to reduce the final period exemption from 18 to nine months. This allows the final period of ownership to be covered by PRR even if the property is not the only or main residence during this period.

The second restriction is to lettings relief, which reduces the gain on a property qualifying for PRR by up to £40,000 per owner, where the property was let to residential tenants for part of their period of ownership. Going forward, this relief will only apply where the owner is in shared occupancy with a tenant.

### *Clarification of Inheritance Tax Trust Settlement definition*

The Government will introduce legislation in the Finance Bill 2019-20 to reflect HMRC's established legal position in relation to the Inheritance Tax (IHT) treatment of additions to existing trusts such that additions of assets by UK-domiciled (or deemed domiciled) individuals to trusts made when they were non-domiciled are not excluded property. The legislation will apply to IHT charges arising on or after the date on which Finance Bill 2019-20 receives Royal Assent,

whether or not the additions were made prior to this date.

In the absence of draft legislation, this appears to be a clarification of HMRC's view as several leading commentators had previously argued that once a trust had been created by a non-dom and hence was an excluded property trust, it remained so even if the settlor then added property once they were UK domiciled.

Legislative amendments will also be made to ensure that transfers between trusts made after the date on which the Finance Bill 2019-20 receives Royal Assent will be subject to additional excluded property tests. As no draft legislation has yet been published it is not possible to speculate at this time as to what the impact of this measure will be.

### *Indications of future change*

New legislation will be introduced in Finance Bill 2019-20 to allow HMRC to make directors and other persons involved in tax avoidance, evasion or regularly liquidating and setting up new companies jointly and severally liable for company tax liabilities where there is a risk that the company may deliberately enter insolvency.

### **Consultation on the "Taxation of Trusts – A Review"**

The UK Government has published a [consultation document](#) setting out the principles of fairness, transparency and simplicity that the UK Government believes should underpin the taxation of trusts. It gives examples of areas identified where the current rules do not meet these principles and seeks views and evidence of the case for reform of these and other areas. Below are some key examples. The document has been informed by research conducted by IPSOS MORI on behalf of HMRC: ["Exploring the use of Trusts"](#)

### *For offshore trusts*

The Government is to undertake a review of offshore trusts to improve fairness, but carving out the special regime they recently have created for non doms. Transparency is identified as a key issue and the Government is concerned that non-resident trusts may, in some circumstances, be used to evade or avoid tax.

### *For UK trusts*

The Government is to review the following favourable aspects of UK trusts:

- 10 year regime looks cheap after first generation or for certain Will Trusts (for further text see below);
- trustees' expenses deduction is more generous than that for individuals;
- *Hastings Bass* principle is only available to trustees; and
- trust capital receipts which are only taxed at basic rate.

The consultation closes on 30 January 2019.

### **New HMRC guidance on Making Tax Digital and six month deferral for complex businesses**

On 17 September HMRC published new Making Tax Digital (MTD) guidance aimed directly at affected businesses. This includes those for whom MTD will be mandatory when it is implemented in April 2019 and any that may wish to volunteer for it. Although the title refers rather confusingly to VAT businesses and other VAT entities, the language of the actual document is both simple and clear. It sets out what will need to be done to be ready for MTD in April 2019. The guidance is very much focused on obtaining the MTD compatible software that will be needed, including 'bridging software' which it is expected many businesses will use to submit VAT returns.

Many businesses currently maintain digital records (either an accounting package or spreadsheets) and use a spreadsheet to perform the final calculations for their VAT returns. Currently those final VAT numbers are then keyed in manually to the '9 box return' on the HMRC portal but, when MTD is introduced, this manual process will need to be replaced by a digital link. The simplest solution for many businesses in this position will be to use 'bridging software' to provide the final digital link from the 9 box return numbers on the spreadsheet to HMRC systems. Digital submission of the VAT return will be required immediately once MTD is live as no soft landing period will apply to this, unlike the MTD requirement for digital links between different parts of the accounting records where HMRC are allowing an extra year for businesses to be fully compliant.

To read HMRC's newly published guidance please [click here](#).

Further to the new guidance, on 16 October HMRC announced that they have "listened to concerns and will give a small group of customers with more complex requirements a further 6 months to prepare". The mandatory start date for Making Tax Digital for VAT will remain April 2019 for the majority of businesses but, for some, this will be deferred until October 2019. As the list of deferred businesses includes all those within VAT groups and VAT divisions (amongst others) this revised start date should benefit the vast majority of large complex businesses and should also allow them the chance to take part in the pilot which will be opened to them in 'spring 2019'. Alongside this, HMRC announced that the MTD VAT pilot is now open to many other businesses with more straightforward VAT affairs and also published a timeline of when remaining businesses will be able to join.

The revised timeline for when businesses can join the pilot and the two mandatory start dates can be found in an updated version of HMRC's 'Overview of Making Tax Digital' policy paper. The businesses that will have the new deferred start date of October 2019 are defined by HMRC as follows:

"The 6-month deferral applies to customers who fall into one of the following categories: trusts, 'not for profit' organisations that are not set up as a company, VAT divisions, VAT groups, those public sector entities required to provide additional information on their VAT return (Government departments, NHS Trusts), local authorities, public corporations, traders based overseas, those required to make payments on account and annual accounting scheme users."

The one year 'soft landing' whereby digital links within a taxpayer's digital records do not need to be in place until April 2020 is not mentioned but, until HMRC provide clarification, it would seem prudent to assume deferred businesses will still be required to have digital links in place by April 2020, i.e. effectively a six month soft landing.

Also noteworthy within the new timetable is information on when partnerships and businesses that trade with the EU (other than those that are deferred) will be able to join the pilot. Private testing (i.e. invitation only) will commence in 'late 2018' and the public stage of the pilot for these taxpayers will go live in 'early 2019'. Given the mandatory start date for these businesses remains April 2019 this gives only a very short window for proper testing.

The deferral for more complex organisations is extremely welcome and follows consistent and overwhelming feedback from stakeholders, including KPMG in the UK, that MTD should not be made mandatory for these businesses before it has been proven to work end-to-end including in HMRC's systems for tracking the return and payment information. The timeline is still quite tight for other taxpayers given the pilot has only just opened for wider participation. Stakeholders will be watching closely to see how the system works in practice as larger numbers join in the weeks ahead. If widespread problems are experienced it is to be hoped that HMRC will continue to listen to concerns raised and only press ahead with mandation once all stakeholders are confident that MTD is running smoothly.

### HMRC's consultation on Short Term Business Visitors

HMRC's [consultation](#) on simplifying the tax and administrative treatment of Short Term Business Visitors ("STBVs") from overseas branches of UK companies closed on 6 August 2018.

The consultation proposes two alternatives to reduce payroll administration for UK companies whose overseas branch employees visit as STBVs:

- Extending the UK workday limit for participation in the special annual PAYE scheme; and
- A new tax exemption for STBVs from overseas branches.

Under the first option, HMRC propose to extend the qualifying limit for the annual PAYE scheme from 30 to 60 UK workdays.

This would affect STBVs both from overseas branches and from overseas subsidiaries in countries that do not currently have a Double Tax Treaty ("DTT") in force with the UK (e.g. Brazil).

The second option would introduce a new and specific tax exemption for STBVs from overseas branches. Its aim would be to align the treatment of STBVs from overseas branches with that of STBVs from overseas subsidiaries who are exempt from UK tax under a relevant DTT.

This would likely include a PAYE relaxation and reporting requirements similar to the current Short Term Business Visitors Agreement ("STBVA") requirements (see [here](#) for a summary of the current STBVA regime).



KPMG UK's Global Mobility and Employment Tax experts responded to the consultation.

A copy of their response is available [here](#).

The key points are summarised below.

- Reform is needed

The current process of managing, tracking and processing payroll for STBVs who participate in the annual PAYE scheme can generate costs that would not have been incurred had they been employed by an overseas subsidiary.

The UK Government's proposals to reduce this administrative burden and maintain the UK as an attractive base for international business are welcome.

- An exemption is the preferred approach

An exemption which, in effect, brings the treatment of STBVs from overseas branches into line with that of STBVs who currently qualify for an STBVA would do most to ease the administrative burden.

- Further improvements to the annual PAYE scheme

In the event that an exemption is not considered to be the appropriate way forward, KPMG UK recommend that further reforms be made to the annual PAYE scheme.

In addition to extending the qualifying UK workday limit from 30 to 60 days, KPMG UK recommend that:

- The reporting obligations be relaxed (it can be challenging to meet these by the 19 April deadline);
- HMRC issue a formal certificate of UK tax paid to assist with foreign tax credit claims in the overseas jurisdiction; and
- The scheme be extended to include directors.

HMRC is currently analysing submissions to the consultation and will publish its responses in due course.

## OECD report – Tax Policy Reforms 2018

On 5 September 2018, the OECD published its annual report on recent tax policy reforms around the world.

The report covers 38 countries and looks at major tax policy trends and recent initiatives. It highlights the significance of economic stimulus driven by tax policy setting, as countries use tax reform to lower taxes on business and individuals to boost investment, and examines the effect of recent significant tax reforms in certain nations including the United States.

Key findings from the [report](#) include:

- The ongoing trend of lower corporate taxes, which has been driven by tax reforms in countries with traditionally high corporate tax rates. The average corporate income tax rate across the OECD has dropped from 32.5 percent in 2000 to 23.9 percent in 2018. In his editorial Pascal Saint-Amans comments that "the countries that introduced corporate tax rate cuts in 2018 included some of the countries that had the highest tax rates in 2017. If anything, these countries appear to be engaged in a 'race to the average' rather than in a 'race to the bottom', with their recent corporate tax rate cuts now placing them in the middle of the pack. There will be much interest in observing how countries respond to this trend in the future";
- A look at the effects of major tax reforms in the United States, Argentina, France and Latvia, as well as smaller reforms in other nations;
- The introduction of new excise taxes to deter harmful consumption, such as sugar taxes; and
- Other tax reform trends, including personal income tax cuts and the introduction of earned income tax credits, and indirect tax rate stabilisation and environmental taxes.

## Legal agreements in transfer pricing: aligning form and fact in a post-BEPS world

A key aim of the OECD BEPS project was to counter arrangements where the "allocation of profits is not aligned with the economic activity that produced the profits", a measure intended to help revenue authorities target artificial tax structures. On one hand, this poses a threat where group entities receive more profit than they deserve - despite what the intercompany legal agreements may purport. On the other hand, it also provides an opportunity to defend structures where 'substance' and reward are indeed aligned but the intercompany legal agreements are inaccurate. This however can be a difficult defence to apply in practice - even in jurisdictions like the UK which have embraced the updated OECD guidance. With the updated 2017 OECD Guidelines applicable in the UK for

accounting periods beginning on or after 1 April 2018, it is an opportune time to review intercompany legal agreements and ensure they are accurate.

### *What is the transaction?*

The concept of economic substance permeates throughout the BEPS Actions 8-10 Final Report and the updated 2017 OECD Guidelines, and should be used to accurately delineate a given transaction. One of the core principles is that the actual conduct of related parties will either supplement or potentially supersede intercompany legal agreements for transfer pricing purposes. The transfer pricing analysis would then be based upon this 'truer' or 'more complete picture' including the actual conduct of the related parties – that is, the economic or factual substance of the intercompany arrangement - rather than being solely based on the intercompany legal agreements.

For instance, the 2017 Guidelines state in Chapter 1 that "written contractual agreements... provide the starting point for delineating the transaction".

They then go on to state that "the written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis", and "if the characteristics of the transaction... are inconsistent with the written contract between the associated enterprises, the actual transaction should generally be delineated for purposes of the transfer pricing analysis in accordance with the characteristics of the transaction reflected in the conduct of the parties".

Similar language is repeated and emphasised numerous times throughout the 2017 Guidelines.

The prior 2010 OECD Guidelines also acknowledged the above concept, albeit in a comparatively cursory manner. Under the 2017 Guidelines, there is now therefore much clearer and stronger technical grounds for contractual arrangements to be ignored if they are incomplete or inaccurate.

### *Does this mean intercompany legal agreements are irrelevant?*

Despite the above, perhaps surprisingly, it is nonetheless vital to ensure that intercompany legal agreements exist and are accurate. This is because in practice, legal agreements are still the starting point for transfer pricing analysis. If a taxpayer argues that the substance differs to its intercompany legal agreements, the taxpayer will be arguing against its own documented position.

Two practical consequences that result from this include:

- Arguing that the facts differ in substance to the legal agreements will require detailed factual evidence to be gathered to ascertain and document the extent of any difference. This can turn into a potentially time-consuming and difficult exercise, which at a minimum should be carried out by the time of filing the tax return; and
- In the context of a dispute, if this fact-gathering exercise has not yet been done, this will become more difficult to carry out and prove as corporate memory fades over time, or relevant personnel leave the company. Furthermore, a taxpayer arguing against its own legal agreements naturally raises questions regarding its intentions at the time of putting the agreements in place, and the taxpayer's credibility more generally. This can further complicate the ensuing dispute.

Where no intercompany legal agreements exist, similar types of issues can arise as there is no historical evidence of the planned arrangement between the parties. In other words, there is no ex-ante reference point to corroborate the taxpayer's ex-post argument.

Therefore, in either case, the misalignment between the legal 'form' and the facts is likely to complicate the practical realities of taxpayers defending their transfer pricing.

### *Our recommendation*

Taken together with the broader measures undertaken as part of the BEPS project, the priority for taxpayers should be to review their tax and transfer pricing arrangements to ensure that policies are appropriately rewarding group entities and are being correctly implemented. This should be documented as part of the yearly tax return process through the preparation of OECD-compliant transfer pricing documentation.

Equally, for the reasons outlined above, taxpayers should review their intercompany legal agreements to ensure that they reflect the factual substance. It is good practice for contractual arrangements to align to the behaviour of group entities. Despite the clear guidance in the 2017 OECD Guidelines, even if substance and reward are indeed aligned, successfully defending this in practice without accurate contractual arrangements being in place is another matter.