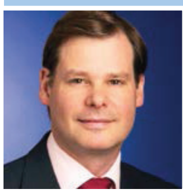
Analysis

The international briefing for March

SPEED READ The OECD BEPS project continues to dominate the international tax world with the UK government's view published alongside the Budget and further significant discussion drafts published by the OECD itself. Draft legislation has been published to remove the extended time limit restriction introduced in FA 2007 that impacted certain EU claims and, staying with EU law, the AG has issued an opinion on the Dutch fiscal unity rules. In Switzerland, guidelines on the taxation of principal companies have been published which could impact groups which already have or are planning to establish principal company structures there.



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The big event this month was the chancellor's Budget, but unusually there was very little of significance announced in the international tax area. Of most note was a paper published by the government alongside the Budget documents which discusses the OECD's action plan on base erosion and profit shifting (BEPS). This paper sets out the key factors that the government will take into account when developing its policy towards the BEPS negotiations, and discusses each of the 15 actions to address BEPS. The paper confirms that the government is committed to the ambitious BEPS project timetable. It considers that international cooperation is the only way to counter tax avoidance in the global economy and that acting unilaterally would be ineffective and counterproductive. It also sets out the principles that the government will follow in assessing any solutions developed through the BEPS process.

While there is clear support for the different actions, the paper makes the following important points:

- **Strengthening CFC rules (action 3):** The government's view is that, having recently reformed the UK's CFC rules, it is not anticipated that the UK rules will require further substantive changes.
- **Limit base erosion via interest deductions (action 4):** In the design and application of any structural interest restriction rules (e.g. earnings-stripping rules or interest allocation across the group), careful consideration will need to be given to the impact on infrastructure projects and the financial sector.
- **Counter harmful tax practices (action 5):** One of the focuses here is on how to more clearly define the requirement for 'substantial activity' in a jurisdiction for companies to qualify for preferential tax regimes. The government believes that most of the activities currently qualifying for the UK patent box would meet any such substance test.
- **Country by country reporting template and transfer pricing documentation (action 13):** The government's view is that the aim of country-by-country reporting should be to provide tax authorities with high-level information to help them efficiently identify and assess risks without imposing a significant compliance burden on businesses.

The government is quite correct that international cooperation is the most effective way to address these issues but it will be interesting to see in practice how it evaluates the different BEPS proposals against its stated principles.

The OECD has also been busy this month pushing forward the BEPS action plan and we have had discussion drafts in two areas published recently with another expected imminently at the time of writing.

On 14 March, a discussion draft titled *BEPS action 6: Preventing the granting of treaty benefits in inappropriate circumstances* was published. The draft focuses on model treaty provisions and recommendations regarding their design to prevent the granting of treaty benefits in inappropriate circumstances. A three-pronged approach is recommended as follows:

- include in the title and preamble of tax treaties a clear statement that the contracting states wish to prevent tax avoidance and avoid creating opportunities for treaty shopping;
- include in tax treaties a limitation on benefits (LOB) article (a 'derivatives benefits' provision is also discussed); and
- include in tax treaties a more general anti-abuse rule (GAAR). This aims to deny treaty benefits, if obtaining the benefit was one of the main purposes of an arrangement or transaction.

The introduction of a wide LOB clause is likely to be unpopular. It could create unnecessary compliance costs and deny benefits in legitimate situations. While LOB clauses are common in US treaties (and some Indian and Japanese treaties), not many other countries use them and the practical difficulties that frequently arise when determining eligibility for treaty benefits under a LOB clause may explain why they have not been popular to date. Introducing a GAAR into a treaty, together with explanatory commentary, would be a more palatable approach to dealing with treaty abuses than a LOB clause, but detailed commentary would be required and more examples provided than those in the draft.

The draft also considers specific anti abuse rules to address other situations when a company seeks to circumvent treaty limitations. This results in proposals to introduce a minimum shareholding period prior to obtaining a lower rate of tax on dividends, a move towards competent authorities determining residence by mutual agreement rather than place of effective management, and limitations on treaty entitlement to payments to permanent establishments (PEs) whose income is subject to an aggregate tax rate (incurred in the PE and residence state) of 60% of what would have been the tax in the residence state.

Then, on 19 March, two discussion drafts on action 2 (to neutralise the effects of hybrid mismatch arrangements) of the BEPS action plan were published. The first sets out various recommended changes to domestic laws covering hybrid instruments, hybrid entities and imported mismatches (including reverse hybrids). The second discussion draft discusses the interaction of the OECD Model Treaty with domestic rules and sets out recommendations for further changes to the Model Treaty and Commentary to clarify the treatment of hybrid entities. It includes: proposals around mismatches between domestic and treaty concepts of corporate residence; limitation of treaty benefits for certain transparent entities where neither contracting state treats, under its domestic law, the income of an entity or arrangement as the income of one of its residents; and double taxation relief in the case of hybrid dividend payments.

There are tight deadlines for comments, particularly for the draft on treaty abuse where comments have been requested by 9 April. The deadline for the two drafts on hybrids is marginally more generous at 2 May but, even so, this is still challenging given the number of proposals that are being consulted upon as part of the BEPS project.

EU update

Removal of extended time limit restriction: On 28 February, HMRC published draft legislation amending FA 2007 s 107. This provision was originally introduced in an attempt to retrospectively remove the extended limitation period arising under Limitation Act 1980 s 32(1)(c), which benefited existing High Court claims for repayments of direct tax made under a mistake of law.

The introduction of s 107 affected claims that had already been made by taxpayers in the long running *FII GLO* litigation, which concerned the UK's tax treatment of cross-border dividends prior to 2009 under EU law and the legality of the old ACT regime. In May 2012, the UK Supreme Court decided ([2012] UKSC 19) that this retrospective provision offended principles of effectiveness and the protection of legitimate expectations and was therefore unlawful.

Rather than repealing s 107 in its entirety, the effect of the proposed change to the legislation is that the extended limitation period will remain where it applies to mistake-based High Court claims, arising from breaches of the EU Treaty freedoms and issued prior to the date of the introduction of s 107.

The proposed change is not relevant to taxpayers with High Court claims made after 8 September 2003, as FA 2004 s 320 removed the right to make High Court mistake claims as of this date. HMRC has yet to respond to the CJEU's recent decision in the *FII GLO* (C-362/12) dated 12 December 2013 that the introduction of FA 2004 s 320 was also unlawful.

***SCA Group Holding* joined cases:** On 27 February, advocate general Kokott (AG) of the CJEU issued her opinion in the *SCA Group Holding* joined cases (C-39/13, C-40/13, and C-41/13). The case concerns two basic scenarios. The first involves a Dutch parent with a German subsidiary which itself owned a Dutch subsidiary. The second involves a German parent holding three Dutch (sister) subsidiaries. In both cases the Dutch companies had applied to form a fiscal unity (a kind of group consolidation) for corporate tax purposes and in both cases this had been rejected. In the first case, this was because the intermediate company was resident in Germany and in the second case because the parent company was resident in Germany. In both cases, a fiscal unity would have been possible between all the companies involved if they had all been resident in the Netherlands.

Unsurprisingly the AG, following previous case law, decided that the Dutch rules are contrary to the freedom of establishment. She considered but rejected a number of possible justifications for these restrictions. She felt that a justification based on the double use of losses could not form an independent justification but, even if it could, the Dutch rules were not an appropriate way of preventing this. The AG accepted the argument that the double use of losses might interfere with the coherence of the Dutch tax system but her view was that less far-reaching solutions could be found than an outright refusal to allow a fiscal unity.

This opinion is fairly uncontroversial and it is very likely the CJEU will reach a similar conclusion when the final decision is published in a few months' time.

Global update

Switzerland – taxation of principal companies: The Swiss federal tax administration recently published guidelines on the taxation of principal companies, which could impact groups that already have or are planning to establish principal company structures in Switzerland. The guidelines introduce new, more stringent conditions that have to be met in order to apply the principal companies regime.

As background, the regime applies to a Swiss resident company which acts as the principal for all sales in a region with local distribution companies resident overseas. Profits are allocated between the principal company and the foreign distribution companies and a certain part of the distribution profit is regarded as not taxable in Switzerland.

The guidelines include the following new requirements: the distributors need to be exclusive and economically dependent on the Swiss principal (i.e. at least 90% of the distributor's profit relates to the group's principal business); the distributor's gross margin cannot exceed either 3% of its revenue or operating expenses, if higher; and key functions and risks of the trading business have to be allocated to the Swiss company. If such functions are outsourced, the principal company benefits may be reduced.

For existing principal companies, the new conditions will apply from 2015/16, whereas new principal companies will have to comply with the rules with immediate effect.

Groups with such structures in place may wish to review and potentially reorganise their operations to ensure unexpected tax charges do not arise as a result of these changes. ■

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