Briefing

International briefing for July

Speed read

Brexit has been dominating the headlines, with the publication of the UK government's white paper on future relations with the EU and two Brexit-related bills passing through the House of Commons. The OECD has published discussion drafts on transfer pricing matters. Further countries have signed or ratified the BEPS multilateral instrument. In the EU, there have been two tax cases decided by the CJEU, and two member states have taken steps to implement ATAD. In local country news, Italy has provided guidance on R&D tax credits, while India provided guidance on the 'place of effective management' rules for foreign companies. On digital tax, the EU has promised 'a modern and balanced regulatory framework' for the digital economy; and the US Supreme Court has ruled that physical presence is no longer a prevailing standard that can be relied on by taxpayers for US state sales and use tax purposes.

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Anyone hoping for a gentle start to the summer will have been disappointed: in the space of just seven days we had breaking news on Brexit positions (the Chequers agreement, the resignations of David Davis and Boris Johnson, the publication of the government's Brexit white paper), the highs and lows of President Trump's European visit, the heart-warming rescue of the Thai Wild Boars and of course the Football World Cup. And for those of us in the tax world, we had the publication of the OECD's long awaited financial transactions discussion draft, the UK draft Finance Bill clauses as well numerous other announcements from the OECD.

Brexit: some clarity on the horizon?

We start this week with a brief summary of the UK government's white paper, published on 12 July 2018, which sets out the most detailed negotiating position to date. At the time of writing, the associated Customs Bill and Trade Bill have been debated in the House of Commons, although the discussions remain fluid.

Business has tentatively welcomed the proposals, although there remain a number of areas of concern. The position on the trade of goods sets out a 'common rulebook' to achieve as frictionless trade as possible. In practice this means consistency in UK and EU standards, and the associated administration and controls. The paper also sets out a 'facilitated customs arrangement' to align the UK and EU's positions for goods entering the region from third countries. Also welcomed were the various proposals for freedom for workers, which set out a process for mutual recognition for professional qualifications.

However, less well received were the positions on services, where a more distant relationship with the EU is proposed. The UK will seek arrangements with a broad coverage across service sectors in line with the WTO's General Agreement in Trade in Services, and has specifically said that it will no longer operate the EU's 'passporting' regime.

We should expect a detailed response from the EU on the UK's proposal in September, in anticipation of agreement of a mutually acceptable position in the Autumn.

OECD updates

This month has seen the publication of the discussion draft on transfer pricing of financial transactions. This highlights the importance of accurate delineation of a transaction before its pricing. The paper also provides guidance on specific transactions, such as activities conducted by a treasury function, guarantees and captive insurance. It is noted that the guidance is not intended to prevent countries from implementing approaches to address capital structure and interest deductibility under their own domestic law. The OECD has invited comments to be provided by 7 September 2018.

The OECD also published two reports covering guidance on hard-to-value intangibles (HTVI) and the transactional profit split method (PSM). The HTVI report aims to provide a common understanding among tax administrations and reduce double taxation risk by outlining principles to clarify the HTVI approach. The second report provides numerous examples on how to apply the PSM and the circumstances in which it should be applied.

Multilateral instrument agreement (MLI)

On 27 June 2018, Kazakhstan, Peru and the UAE signed the BEPS MLI increasing the number of covered jurisdictions to 82. Meanwhile, Serbia, Sweden and New Zealand have ratified the MLI; it will enter into force for these countries on 1 October 2018 and will see their existing bilateral tax treaties transpose the BEPS measures relating to hybrid mismatch arrangements, treaty abuse, permanent establishments (PEs) and dispute resolution.

Luxembourg has released a bill to ratify the MLI into domestic law, which will simply approve the text of the MLI as initially signed by Luxembourg in June 2017. There is currently no defined timeline on the completion of the process. The French Parliament has also passed a bill authorising ratification of the MLI on 5 July 2018 which is expected to be effective in 2019.

As noted in previous articles, the UK has also recently ratified the MLI and, on 16 July, HMRC published the final list of UK reservations and notifications made on deposit of the instrument of ratification. It will therefore be important to check back to this list when applying the MLI to transactions to which the UK is party to ensure its correct application.

EU updates

As anticipated a couple of months ago, the new EU mandatory disclosure regime (MDR) has now come into force from 25 June 2018. The impact of the MDR is that disclosure is required where cross-border arrangements fall within certain hallmarks which have been separated into categories. The first two categories (A and B) only apply where the main benefit of the arrangement is to obtain a tax advantage known as the tax main benefit test. Category C includes elements which are subject to the tax main benefit test and categories D and E are not subject to the test.

We have also seen further publications from the CJEU. The CJEU published its decision in *NN A/S* (Case C-28/17) concerning the compatibility of the Danish Rules on deductibility of losses from a Danish PE whose head office is not tax resident in Denmark with EU law. Regular readers may feel a sense of déjà vu, but last month's Danish CJEU's case was actually a Danish company with a Finnish PE.

In this case, NN A/S, a Danish resident company, sought to offset tax losses of their Swedish subsidiaries Danish PE against its own profits. The local tax authorities rejected this as it was argued that Danish PE losses can only be offset against the profits of a Danish tax group if they cannot be used in the jurisdiction of the PE's head office, a decision which NN A/S later appealed. The CJEU concluded that the Danish legislation is a restriction of the freedom of establishment and may only be justified to prevent double deduction of losses in both Denmark and Sweden. This is similar to *Philips Electronics* (Case C-18/11); however, the court had previously rejected the prevention of double use of losses as justification in those circumstances. The court has left it to the national court to assess whether the application of the legislation is appropriate in the circumstances.

The CJEU also issued a final decision in the *Heitkamp Bauholding GmbH* (Case C-203/16) (HBH) concerning the compatibility of EU state aid rules with the German 'reorganisation clause' where, under certain conditions, a company in financial difficulty can carry forward tax losses despite changes in its shareholder structure.

In 2011, the European Commission (EC) concluded that the clause amounted to unlawful state aid (2011/527/EU) and ordered Germany to withdraw the scheme. This led to the German Ministry of Finance suspending applications which ultimately denied HBH the benefit of the scheme to which they would have otherwise been entitled. HBH brought action to the General Court of the European Union seeking to annul the decision, which was dismissed in February 2016 (T-287/11). HBH then appealed to the CJEU, which has ruled that the EC's decision is to be annulled without it being necessary to further examine whether the German rules are selective, or constitute a derogation to the reference system.

Anti-Tax Avoidance Directive (ATAD)

With the implementation date of the ATAD approaching (1 January 2019), we have seen some activity to implement its requirements at a local level.

The Luxembourg government's council approved a bill to integrate the ATAD into domestic tax law. The bill covers five aspects of the ATAD, being: hybrid mismatches; CFC provisions; interest deductions; a general anti-abuse rule; and exit taxation.

The UK has also taken steps (in the draft Finance Bill 2018/19) to implement measures to align with the ATAD for both CFCs and hybrid mismatches. It is proposed that the CFC rules will be amended to change the definition of control such that interests held by associated enterprises are taken into account, and to restrict the availability of the so-called 'FinCo exemption' for certain non-trade finance profits. In addition, extensions to the hybrid mismatch rules are proposed, to apply the rules to situations where a UK resident company attributes a receipt to a foreign PE but that other territory does not recognise a PE.

Local country updates

Italy

Guidance has been released to clarify the application of the research and development (R&D) tax credit which had been made available to Italian companies and PE's from the 31 December 2014 up to 31 December 2020. The credit is capped at €20m per beneficiary and granted on the condition that the total investment in R&D for the fiscal year is at least €30,000.

Recent clarifications state that a software development project can be classified as R&D investment if:

- its implementation depends on scientific and/or technological progress; and
- the purpose of the project is the systematic solution of a scientific and/or technological issue.

The Italian Tax Authority Circular no. 10/E/2018 reiterated that the R&D tax credit measures should be interpreted according to the nature of the incentive and its purpose, which is to increase investments in R&D. Furthermore, Italian Tax Authority Ruling no. 46/E/2018 has specifically listed six cases that do not qualify as eligible R&D activities.

India

India's Central Board of Direct Taxes (CBDT) provided guidance on the 'place of effective management' (POEM) standards and implications for foreign companies. The guidance sets out transitional provisions for a foreign company that is deemed to be Indian resident based on the POEM rules. These include the writing down value of a depreciable asset, brought forward losses, unabsorbed depreciation and rules relating to tax deduction. The guidance is effective from 1 April 2017 and thus has retroactive application.

Digital tax

No 2018 tax update is complete without a mention of the digital economy and so we end this month's article with a brief word on digital taxation. On 1 July, Austria took over the EU presidency from Bulgaria and has promised 'a modern and balanced regulatory framework' for the digital economy, with rumours that the EU was poised to make a joint announcement on the subject; however at the time of writing, we are still being kept waiting.

Also on the subject of the taxation of the digital economy (albeit in relation to sales tax rather than corporate tax), the US Supreme Court's decision in *South Dakota v Wayfair Inc* (2018) 585 US case has given some clarity to the stance that the US may take going forward: broadly, that a physical presence is no longer a prevailing standard that can be relied on by taxpayers for US state sales and use tax purposes. Prior to the decision of this case, US case law dictated that an entity must have a physical presence, or a nexus, for sales and use tax to be levied by that state. This was later described by the court as 'unsound and incorrect'. The state of South Dakota had enacted a pure economic nexus statute in May 2016 for state sales and use tax purposes that applied to all entities (subject to a de minimis), regardless of physical presence. The court essentially agreed that South Dakota had the power to enact such economic nexus rules – although the decision has been remanded (i.e. resent to the local court), so the timing on the resolution is somewhat uncertain. All that can be said for certain is that the landscape has changed significantly. ■

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