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# *How BEPS impacts...* UK multinationals

This briefing considers the implications for UK multinationals of the OECD base erosion and profit shifting (BEPS) recommendations. It is designed primarily for the non-tax specialist.

## What is BEPS?

BEPS refers to tax planning strategies that take advantage of gaps and mismatches between national tax rules to enable profits to be shifted to low-tax jurisdictions where there may be little economic activity, or to generate excessive reliefs in high-tax jurisdictions, resulting in a reduced overall corporate tax burden.

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The project reached a significant stage in November 2015 with the approval by G20 leaders of a complete package of OECD recommendations addressing 15 areas (or Actions). The recommendations contemplate far-reaching international tax reforms, which can broadly be divided into three areas or objectives:

- proposals that seek to ensure that taxable profits are more closely aligned with operational substance;
- proposals aimed at restricting techniques, such as intra-group debt and 'hybrid instruments', intended to generate excessive reliefs in high-tax jurisdictions (not matched by tax on the corresponding income); and
- proposals to increase transparency of cross-border tax structures and the sharing of information between tax authorities.

Domestic implementation of the proposals should now follow in many countries, although the timing and extent of adoption will vary per country, and OECD work continues on a number of matters, including a proposed multilateral instrument to modify bilateral double tax treaties.

### The EU's response

While the OECD BEPS-related changes are intended to be far-reaching, it is notable that the EU has indicated a desire to go further. A draft EU Directive has been circulated by the European Parliament as a proposed common response to certain BEPS Actions, which if agreed (no easy thing to achieve) will go beyond the OECD recommendations. The European Commission has also been active in challenging national tax rulings and preferential regime-based planning structures on state aid grounds.

### The UK's response

The UK is an enthusiastic supporter and early adopter of the OECD proposals. Work is already well advanced on developing domestic law rules to reflect what is required in the context of 'hybrid mismatch' arrangements and restricting interest deductions through an 'interest barrier'. The Finance Act 2016 will ensure that new OECD transfer pricing guidelines are reflected in domestic law, and legislation is already in place for country-by-country reporting. In addition the UK Budget includes a proposed new royalties withholding tax regime, inspired by the BEPS project.

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The key OECD Actions and the UK implementation of them are summarised further in the Appendix.

## Headline questions for multinationals

The OECD proposals and associated national tax reforms raise many questions for multinationals, including the following.

- Does your group corporate structure or intra-group supply chain need to change? Do you need to move people and assets to ensure an appropriate level of operational substance in profitable jurisdictions? Will offshore IP structures still benefit from preferential tax regimes?
- Does your group treasury function need to be restructured? Does your overall level of group debt need to change? Are internal debt arrangements still viable/efficient?
- Might some businesses be more efficiently funded (and more valuable) in different ownership?
- In some cases, will uncertainty create an issue for new debt financings or refinancings? Might there even be default risk under existing third-party debt terms?
- Acquisitions and disposals – What is the impact of BEPS on structuring? For example, can planning advantages assumed in modelling an acquisition structure be seen as robust for the medium to long term? And what is the impact on due diligence? Due diligence may need to test the reliability of existing arrangements in a BEPS context.
- Going to market – Are there BEPS risk factors that should be considered now for prospectuses and other circulars?
- Is your effective tax rate likely to increase? What might the market impact be and what disclosure is appropriate, eg in financial statements?
- Could enhanced transparency and exchange of information lead to increased litigation with tax authorities? How can you protect your commercially sensitive data when it is shared with overseas tax authorities?

Boards, GCs, deal teams and treasury teams will need to consider these and other issues carefully over the coming months.

## Contacts

Please let us know if you would like to discuss the contents of this briefing, or any other aspects of the OECD's BEPS project and the implications for your business, in detail.

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## APPENDIX
## Key OECD proposals and UK implementation

The OECD BEPS project was divided into 15 detailed Actions, the most significant of which are covered below.

### Hybrid mismatch arrangements (Action 2)

The hybrid mismatch proposals are designed to deny the benefits of different tax characterisation in different countries of financial instruments and deals (eg an instrument treated as debt in one jurisdiction but equity in another) and of entities (opaque versus transparent). The benefits typically involve deductions for payments without corresponding taxable income receipts or double deductions for the same expense.

The UK plans to implement the OECD proposals with complex new domestic hybrid rules in the Finance Act 2016, to take effect from 2017. The rules will apply automatically and without any need for a tax avoidance purpose. They may also go beyond the OECD report in the way in which they deal with certain branch-based structures.

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### Controlled foreign companies (Action 3)

Controlled foreign company regimes are intended to prevent corporations shifting profits into subsidiaries that are subject to a low rate of taxation. They generally operate by taxing the local parent company by reference to profits accruing in low tax subsidiaries. The OECD report made no mandatory recommendations in this regard but set out 'best practice' guidelines for the design of a controlled foreign company regime for those jurisdictions that choose to implement such a regime.

The UK regime for controlled foreign companies based in low-tax or tax-haven territories was recently updated and (subject to anything that may occur at the EU level) is expected to survive. Many groups take advantage, however, of exemptions within the regime for overseas finance companies lending intra group; it is possible that the use of those exemptions will be affected by other Actions (notably hybrid mismatch or interest limitation Actions), and that the exemptions may come under increased scrutiny. For now however the Budget on 16 March has confirmed that no amendments are being considered.

### Interest limitations (Action 4)

For UK multinationals, one of the key OECD proposals is to impose a general limitation or 'barrier' on tax relief for interest. This is designed to protect the tax base against earnings stripping, where members of a multinational group in a high-tax jurisdiction incur excessive net interest expense. Although the UK has some existing measures that can operate to restrict interest relief, the introduction of the recommended rules in the UK will be a significant departure.

Proposals for the shape of a new interest barrier in the UK have been published with the Budget on 16 March 2016 and new rules are expected to take effect from April 2017. In brief the proposed way ahead, which is based closely on the OECD proposals, is now:

- To restrict relief for a group's overall UK net interest expenses by reference to a fixed ratio, being 30% of UK EBITDA, subject to the alternative of a worldwide group ratio test applied locally if that leads to a better result for the taxpayer (based on the overall group borrowing position, using a net interest to EBITDA ratio for the worldwide group) – the group ratio approach is in line with the OECD report but it is a different form of group escape route from that used by some other countries which already have interest barriers.

- To introduce rules to ensure that the restriction does not impede the provision of private finance for certain public infrastructure in the UK where there are no material risks of BEPS. Consideration will also be given to special considerations applicable to upstream oil and gas.

- To include rules to address volatility in earnings and interest – this no doubt involves carry forward and possibly back of disallowed reliefs.

- To repeal the existing UK worldwide debt cap regime, but to replace it by rules with similar effect within the new regime (ie such that UK net interest deductions will not be allowed to exceed group net third-party expense, presumably irrespective of the fixed ratio).
- To include a de minimis threshold of £2m net UK interest expense.
- To consult further on detailed design aspects – this will presumably include grandfathering/transition and related party issues.

Multinationals will have to consider and model the impact of these rules in a variety of forms. Group debt reorganisations may be required. There are also various possible implications for corporate finance activity...

Similar rules are likely to be introduced in other jurisdictions which traditionally, like the UK, have taken a less prescriptive approach to interest relief. Multinationals will have to consider and model the impact of these rules in a variety of forms. Group debt reorganisations may be required. There are also various possible implications for corporate finance activity, for example as to:

- whether some potential buyers would be better able to manage leveraged acquisitions (or leveraged target businesses) than others;
- whether some businesses within a group might be more efficiently financed in different ownership (through spinoff, sale or contribution to a joint venture);
- whether in cross-border acquisitions debt pushdowns are required, immediately or at a later stage, and are achievable at the right time; and
- ultimately what is the appropriate level of group debt.

One of the well-known advantages of the UK tax system for group holding companies has been that interest is generally deductible on UK borrowings even if they are used to finance overseas investments from which the returns are exempt from tax in the UK. That advantage will be eroded by the proposals. It is to be seen however in the context of what will be a low corporation tax rate environment in any event, with rates reducing to 17% by 2020 as announced in the Budget, which will increasingly encourage the location of debt elsewhere.

### Harmful tax practices (Action 5)

The focus of this Action has been preferential intellectual property regimes in particular, including the UK's 'patent box', which enables certain IP-related income to be taxed at a privileged low tax rate (of 10%). The UK regime needs to change, such that access to it is only available where the related R&D activity is located here, and the necessary amendments are to be included in the Finance Act 2016; in addition, there is some grandfathering for IP under the existing regime which may require IP filings or intra-group transfers (before July 2016) if advantage is to be taken of it.

The harmful tax practices Action is also concerned with tax rulings, contemplating spontaneous exchanges between tax authorities.

### Treaty abuse (Action 6)

Planning to take advantage of double tax treaties, typically to avoid source country withholding taxes, already involves a number of issues and difficulties both as a matter of double tax treaty interpretation and under local laws. Recent high-profile cases in Switzerland and elsewhere have been a reminder of this. The treaty abuse proposals will reinforce the concerns and are likely to require a review of the use or substance of intermediate vehicles which are used to route lending into, or to hold and facilitate profit repatriation from, or tax free disposals of, local subsidiaries. Some difficult anti-avoidance provisions are contemplated, especially if, as is one of the options, US-style limitation on benefits provisions are introduced into treaties.

As a related development, the Budget 2016 announced changes to the UK tax treatment of royalties paid overseas. BEPS planning often involves deductible royalties for cross-border IP licences, where the income ends up directly or indirectly in an entity which is low taxed.

Where the payments are made from the UK there is frequently no domestic withholding tax (eg withholding tax does not usually apply to trademarks and brand rights); and if withholding tax might apply double tax treaties are often relied upon to overcome it. The UK tax regime is to be strengthened in the Finance Act 2016 with new rules including:

- an anti-abuse provision, applicable immediately, which applies to override double tax treaty relief that would otherwise be available between connected persons where there is use of a treaty for avoidance – the approach is derived from the OECD treaty abuse report; and

- an extended withholding regime, which encompasses payments typically regarded as royalties in OECD model tax treaties (including trademarks, brand rights and payments for know-how) – the rules will apply from July 2016 when the Finance Bill becomes law.

Existing arrangements will be affected by this change and a number of structures will require review.

### Permanent establishments (Action 7)

The OECD approach is that it has become too straightforward to derive revenues from a country without a taxable presence there, including by the use of agency or near agency arrangements or by relying on specific let outs for activities hitherto regarded as preparatory or auxiliary. Proposed changes are likely to make this more difficult. They will extend to addressing cases where activities are fragmented so that different activities, each of which is said alone to be only preparatory or auxiliary, are carried on within different entities. Similar concerns are reflected, as regards inbound investment to the UK, in the UK diverted profits tax regime introduced in the Finance Act 2015.

The transfer pricing proposals... are designed to ensure... a greater focus on true value creation, underlying substance, control of (and financial capacity to control) risk, and actual decision making.

### Transfer pricing (Actions 8 to 10)

The transfer pricing proposals, which will have domestic effect on the basis of new OECD guidance becoming the reference point for the UK tax regime pursuant to the Finance Act 2016, are designed to ensure, when allocating profit on an arm's length basis between entities, a greater focus on true value creation, underlying substance, control of (and financial capacity to control) risk, and actual decision making. Less weight should be placed on contractual allocations, formal risk assumption or provision of capital without functionality. In the case of intangibles the use of hindsight (taking account of income generated) is also permitted. The transfer pricing proposals are less radical, however, than might have been expected. For example, recharacterisation of deals is still to be avoided except where arrangements are not commercially rational. In this respect the UK's diverted profits tax regime will in appropriate circumstances go further; and it is not presently expected to be repealed following the implementation of BEPS. Nonetheless, there will be a need to readdress existing arrangements, including location of IP, supply chains and location of staff. Group reorganisations may be required to follow, with related issues in a variety of disciplines where additional substance is required including employment, pensions and IP.

Tax investigations and disputes may also be expected to increase as a result of the provision of the enhanced information.

### Transfer pricing documentation/country-by-country reporting (Action 13)

The OECD proposals in this area contemplate documentation requirements involving master files, local files and country-by-country reporting that will provide breakdowns to tax authorities by reference to activities carried on, revenue, profits, tax paid and accrued, employees, capital and tangible assets. Although UK preparations will be well underway, since the UK has been an early implementer (with enabling legislation for country-by-country reporting included in the Finance Act 2015 and implementing regulations introduced in February 2016), this will be an important area in practice: documentation will need to be reviewed, possibly with wider issues in mind, given the uses that may be made of the documentation as a result of relatively wide circulation. Tax investigations and disputes may also be expected to increase as a result of the provision of the enhanced information. The point of it, of course, is to ensure that local tax authorities are better equipped.

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