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UK Emphasis on Stronger Transfer Pricing Rules to Check Base Erosion and Profit Shifting

Vat Guidelines Could Add Extra Layer of Complexity

By James Anderson and Chris Hutley-Hurst (Skadden, Arps, Slate, Meagher & Flom LLP)

Six months have elapsed since the Organization for Economic Co-operation and Development (OECD) released its 15-point action plan to address Base Erosion and Profit Shifting (BEPS). During this time, the OECD has been working toward achieving the goal of the action plan by coordinating with G20 governments, including the United Kingdom.

At its heart, the action plan seeks to eliminate double nontaxation of corporate income and curtail tax minimization strategies that involve the segregation of taxable income from the business activities that generate that income. The action plan also seeks to introduce dramatically increased transparency and information sharing between multinational entities and taxing authorities. It ultimately will affect many multinational tax and business structures, including those not viewed as involving aggressive or abusive planning.

The BEPS Action Plan: UK Implementation

The UK government officially supports the development of rules to implement the 15 points addressed by the action plan. From the UK government's perspective, the most important of these points are:

- preventing erosion through hybrid entities, such as partnerships and Delaware LLCs;
- preventing treaty abuse; and
- updating and strengthening transfer pricing rules (particularly in relation to intangibles).

Digital Economy

The UK government also continues to work closely with the OECD and the EU in relation to reviews of the taxation of the digital economy, which is recognized as an issue to be addressed in parallel to BEPS.[1] Other BEPS action points, such as strengthening controlled foreign company (CFC) rules and reporting tax avoidance schemes, are not seen as areas of legislation that still need large amounts of work in the UK because the government views its existing rules as already fulfilling some of the action points, though there is an effort to refine the rules.[2]

The action plan's two-year timeframe looks challenging.

Transfer Pricing vs. CFC Rules

The UK government also is on record as viewing transfer pricing as a key mechanism to combat BEPS. This is in contrast to the U.S. government, which may be favoring an expansion of CFC rules as a mechanism to deal with BEPS on a residence basis. The UK government has narrowed the scope of the UK's CFC regime—partly in an effort to make the UK a more attractive jurisdiction in which to locate business—and so it is unlikely that the UK's CFC regime will be expanded. These different starting points for the collaborating jurisdictions highlight some of the headwinds the BEPS project may experience.

The UK government (and other EU jurisdictions within the OECD) also must consider EU law, which implements the fundamental "freedoms," such as the freedom of establishment and the free movement of capital. The Court of Justice of the European Union previously has found a prior iteration of the UK's CFC regime to breach the freedom of establishment because, in certain instances, it applied to genuine commercial arrangements (e.g., where a subsidiary company of substance resident in a low-tax EU member state was carrying on genuine economic activities).

The action plan will ultimately affect many multinational tax and business structures, including some not viewed as aggressive or abusive.

Because, under EU law, CFC rules generally should apply only to wholly-artificial arrangements, such governments are unlikely to expand or introduce CFC rules that could tax profits of companies carrying on genuine commercial activities in other EU member states. This is another example of possible disagreement between the U.S. and EU member states as to the direction that some of the BEPS action points should take. The action plan's two-year timeframe looks challenging.

Double Taxation

Pending that implementation of anti-BEPS rules, these issues will have to be addressed using local anti-avoidance provisions, and it is likely that there will be increasing instances of cross-border situations where unilateral actions by tax authorities will lead to double taxation. Taxpayers will need to pressure the UK government and other jurisdictions to improve (i.e., cheapen and streamline) mutual assistance procedures by which the competent authorities seek to agree which jurisdiction has taxing rights in certain circumstances falling within an applicable double-tax treaty. In this regard, implementation of another BEPS proposal would be welcome: compulsory arbitration between countries in cases where the respective tax treaty demonstrably does not solve double taxation.

VAT Guidelines

Much focus in the past year has been on BEPS, which only deals with direct taxation. Separate from the BEPS action plan, the OECD also is reviewing VAT rules and producing guidelines for cross-border supplies of services and intangibles. While these guidelines do not focus on intra-group supplies or those between connected persons, they are helpful in showing the direction that the OECD may take on this issue.

Destination Principle

For VAT, the OECD favors the "destination principle" of taxation, by which the tax charge arises in the jurisdiction where the service/intangible is consumed. This makes sense for VAT because it is a consumption tax, and EU member states generally apply the destination principle for VAT on business-to-business supplies. Starting January 1, 2015, the destination principle also will apply to business-to-consumer supplies of telecommunications, broadcasting and electronic services.

Interestingly, the destination principle is one of a number of possible methods of corporate and income taxation that could be adopted to deal with BEPS. While adopting the destination principle for direct taxation may be attractive to countries with consumer economies, such as the U.S., it is unlikely to appeal to countries with manufacturing economies, such as China, or to countries that already have consumption taxes, such as the United Kingdom.

Apportionment

The draft guidelines also consider the apportionment of a supply for VAT purposes where a business receives services that are used in different branches in different jurisdictions. Two methods are being proposed:

1) the "recharge method," by which VAT on the supply is levied in the jurisdiction of the contractual recipient. Then any internal recharges of the cost of the supply to different branches are treated as payments for separate supplies, which are then taxed. (In general, this currently happens where recharges are between two different entities but not where between different branches of same entity.) This is the preferred method, since it would track recharges that most businesses are expected to make in any event for nontax purposes; and
2) the "direct-use method," whereby the business analyzes which establishment uses what portion of the supply, and VAT is levied in the different jurisdictions accordingly. This is not the preferred method, since it is expected to be administratively burdensome and costly for businesses.

There is therefore some similarity of approach between the VAT guidelines and the BEPS plan, including the direct-use method as a possibility for transfer pricing. It will be interesting to see how the VAT guidelines develop alongside the proposals that are produced under the action plan, especially because the destination principle of taxation is one of a number of possible methodologies that could be adopted to deal with BEPS.

Conclusion

The BEPS action plan remains ambitious in its timeframe, with the potential to dramatically change international taxation. The VAT guidelines could add an extra layer of complexity to the proposals that come out of the action plan. However, it remains to be seen whether the OECD can meet the ambitious deadlines set out in the action plan. There is likely to be some disagreement between governments on various points, and the political will that has driven the BEPS project to date may wane if countries' economies continue to recover in 2014 and 2015.

[1]A report by the EU Commission's High Level Expert Group on Digital Taxation is expected to be delivered in the first half of 2014.

[2]E.g., the UK government has proposed changes to the CFC rules to prevent their abuse by addressing UK base erosion through the transfer of profits from intra group lending offshore, as well as a new information disclosure and penalty regime for high-risk promoters of avoidance schemes. ❑