September 2016

Investment Funds – End of Summer Round-Up

Hello – and welcome to our summary of the summer's tax news for investment funds. There was lots going on and so this is an unapologetic summary – not detailed analysis - please get in touch if you need more information on any of the matters below. And, although it isn't covered in our round-up, we haven't forgotten the biggest news story of the summer – Brexit. A reminder that we are holding a seminar on tax and Brexit on Tuesday 11th October and, if you haven't already registered, please let us know here if you'd like to attend.

Stop press on Pension funds and VAT:

HMRC has just announced a further extension (to 31 December 2017) of the transitional VAT-recovery rules for employers in relation to the administration and management of their pension schemes. It is taking HMRC longer than expected to reconcile an ECJ case (PPG) with pension and financial service regulations, accounting rules and emerging case law. The extension means that employers can continue to use the VAT treatment outlined in VAT Notice 700/17: Funded Pension Schemes (including the 70:30 split) until 31 December 2017. Travers Smith LLP has been (and will continue to be) involved in discussions with HMRC through the pensions industry body.

Disguised remuneration consultation

Published: 10 August 2016.

HMRC is planning a further crack-down on disguised remuneration ("DR") schemes. By way of background, the DR rules were introduced to combat 'loans from trusts' type-planning (as practised by Rangers FC and others).

- The headline is that loans which are outstanding at 5 April 2019 will be subject to tax under the DR rules. Businesses which have implemented DR planning and have not unwound the arrangements or settled with HMRC will have to consider their next steps in light of this long-stop date.

- From next year it will be easier for the DR rules to bite where an individual is a director or employee of *and* a 5%+ shareholder in a close company. In these circumstances, amounts paid to the individual by third parties (but facilitated by the close company) will be taxed as employment income, even if there is no link between the payment and the individual's employment.

- Steps which result in an amount being left outstanding to a third party will be caught DR going forward (even if there is no loan or payment).

- HMRC is also considering broadening their power to pursue the employee rather than the employer for the tax where a DR scheme is used and denying corporation tax deductions for contributions to any such scheme unless a corresponding employment tax charge arises at the same time.

Perhaps more concerning for asset managers is the suggestion in the consultation paper that HMRC may extend the DR rules to self-employed individuals in partnerships: little detail is available, but given the extensive reach of last year's disguised investment management fee rules, more legislation in this area seems unnecessary in relation to fund managers.

Partnership taxation consultation

Published: 9 August 2016

This consultation arises from recommendations made by the Office of Tax Simplification and most of the changes are administrative in nature:

- HMRC proposes that a person will be treated as a partner in a partnership for tax purposes if they are notified to HMRC as such in the partnership return.

- Where multiple layers of partnerships are used (i.e. where one partnership is a partner in another partnership), HMRC will require the partnership at the bottom of the chain to identify the ultimate beneficial owners, although these rules will not be applied to investment funds.

- The profit sharing arrangements in a partnership agreement will be definitive in deciding a partner's share of profits for tax purposes unless HMRC is notified to the contrary. This may be relevant to LLP managers/advisers who set out the details of profit sharing arrangements in separate side letters.

- HMRC also states that partners should not be allowed to allocate or 'cherry pick' specific items. The consultation proposes that the basis of allocating tax-adjusted profit should be aligned with the allocation of accounting profits/losses between the partners.

Double Tax Treaty Passport ("DTTP") Scheme consultation

Consultation closed on 12 August 2016

Under the existing treaty passport scheme, non-UK companies which lend funds to UK companies can apply for a "treaty passport" so that they can receive interest payments without withholding tax. This summer's consultation seeks views on whether the DTTP Scheme should be extended to overseas partnerships as lenders, UK partnerships as borrowers, sovereign investors and pension funds.

HMRC foresees compliance difficulties with including overseas partnerships and have suggested that their passports could have a shorter duration (1-2 years rather than 5) and be contingent on all of the partners being resident in the same jurisdiction. HMRC asks for further information on the type of structures used by sovereign investors and pension funds and whether those are suited to the mechanics of the DTTP Scheme. The consultation follows representations from the Office of Tax Simplification and industry that there is no longer any justification for limiting the scheme to companies.

Taxation of non-UK domiciled individuals consultation: further details published

Published: 19 August 2016

As widely trailed, the non-dom rules will change in 2017 so that non-doms who have been UK resident for 15 out of the previous 20 tax years will be treated as deemed UK domiciled for all tax purposes. The August 2016 consultation expands on a number of the more complex elements of the proposals including in relation to non-doms returning to the UK, relief for mixed fund bank accounts, asset rebasing, inheritance tax on UK residential property, as well as rules in relation to the use of offshore trusts. Non-doms should contact their personal tax advisers to carry out a detailed review of how these changes may affect them and what actions may need to be taken.

Interest deductibility consultation

Consultation closed on 4 August 2016.

HMRC closed its consultation on new rules to restrict the tax deductibility of corporate interest expenses to (broadly speaking) 30% of EBIDTA. Many businesses and industry bodies commented on the far-reaching proposals with a key concern for many respondents (including Travers Smith) being the tight-time frame for the start of the new rules (1 April 2017) and the lack of transitional provisions. Many have highlighted the difficulty for businesses in preparing for the new rules without draft legislation being available, but – at present – HMRC seems determined to press ahead.

Substantial shareholding exemption ("SSE") consultation

Consultation closed on 18 August 2016.

HMRC is exploring whether the SSE could be less complex and more internationally competitive. SSE knocks-out corporation tax on chargeable gains accruing on certain share sales. Currently, for SSE to apply:

- a company (the **"Investor Company"**) must hold at least a 10% stake in a second company (the **"Investee Company"**) continuously for 12 months within 2 years of the date of disposal;
- the Investor Company and the Investee Company must each be a trading company (or member of a trading group) throughout the relevant 12 month holding period and immediately after the disposal;

The consultation set out five options for possible reform:

A. an entirely new comprehensive exemption;

B. removing the conditions relating to the Investor Company;

C. removing the conditions relating to the Investor Company and amending the conditions relating to the Investee Company;

D. amending the trading requirements for both companies to broaden SSE availability;

E. changing the definition of substantial shareholding

The government is also exploring the application of the SSE rules to partnerships. Many respondents (which included Travers Smith) made the point that the SSE, in its current form, is excessively complex, particularly when compared to participation exemptions in other jurisdictions. A full participation exemption system such as those available in Luxembourg, the Netherlands and Ireland would be welcome and would encourage businesses to choose the UK as a holding company location.

Country-by-country reporting ("CbCr") and large business tax strategy developments

Country-by-country tax reporting comes into force this year requiring certain UK businesses within multi-national enterprise groups ("MNE groups") with consolidated group revenue of €750m or more to provide information about the tax affairs of the MNE group to HMRC.

Separately, rules are being introduced this year requiring UK groups which are either MNE groups or UK groups with turnover exceeding £200m and/or a balance sheet total of more than £2 billion, to publish their tax strategy on their websites. Under pressure from some MPs, the government has now added a provision to these rules which gives the Treasury the power to make regulations requiring the published group tax strategy to include a CbCr too, making both publicly available: if HMT uses this power, this would be a significant change.

In addition, the OECD has issued guidance confirming that there is no general exemption for investment funds from CbCr and, instead, the inclusion of investee companies in a fund's CbCr will depend on the accounting consolidation rules. The UK government has indicated that it intends to amend the UK CbCr Regulations to make clear that partnerships are within its scope. Finally, the OECD has confirmed that a number of jurisdictions which are not able to implement CbCr for periods commencing 1 January 2016 (including the US, Russia, Japan and Switzerland) will accept voluntary filing by the ultimate parent entity of a group resident in their country.

EU withholding tax: CJEU decision in Brisal-Auto Estradas do Litoral SA, KBC Finance Ireland v Fazenda Pública (Case C-18/15)

This is a CJEU case with potentially far-reaching implications for withholding tax regimes in EU Member States.

Brisal, a Portugese entity, entered into a financing agreement with a banking syndicate, including KBC, a bank established in Ireland. Brisal was required by the Portuguese rules to withhold tax from certain interest payments made to KBC. Brisal and KBC argued that Portugal's withholding rules imposed a heavier burden on non-residents compared with residents. Non-residents were subject to a 20% withholding tax on gross income whereas, although the headline rate was higher for residents (25%), there was no withholding and the tax rate applied to net, not gross, income.

The CJEU held that, while withholding taxes levied on non-residents could restrict EU freedoms, this could be justified by the need to ensure effective tax collection.

However, it concluded that national legislation which taxes non-resident financial institutions on interest income on a gross basis (where resident financial institutions are permitted to deduct their directly-related business expenses) was a prohibited restriction on the freedom to provide services.

The CJEU's decision is significant as it appears that in order for withholding taxes to be lawful, the net position of the recipient of the interest should be taken into account. The CJEU indicated that the recipient should be able to reclaim excess withholding tax levied directly from the tax authorities. It remains to be seen whether the UK courts will respond with legislation to put such a reclaim mechanism in place. It will also be interesting to monitor how the market will respond - whether by relying on this judgment (including seeking to recover past excess withholding tax), or continuing to consider applicable exemptions.

BEPS – Permanent Establishment Profit Attribution

The OECD invited comments over the summer on a discussion draft paper relating to the attribution of profits to permanent establishments including in relation to the proposed new definition of a dependent agent which will set a lower threshold for an agent's activities to constitute a permanent establishment.

The discussion draft paper set out examples of where a dependent agent permanent establishment ("DAPE") will result in profits being attributable to the agent's activity. The examples show the functional and factual analysis that must be performed to analyse the functions undertaken by the agent looking in particular at the shifting of risk to the agent, economic ownership of assets and significant people function. Investment funds with advisory teams in other jurisdictions will need to consider the implications for their decision-making process carefully.

A public consultation will take place on 11-12 October 2016. The work on the attribution of profits to a permanent establishment is intended to be concluded by the end of 2016.

BEPS - the Multilateral Instrument

In May, the OECD published a short discussion draft on the multilateral instrument. The multilateral instrument is the mechanism that the OECD hopes will be used to modify bilateral tax treaties to implement various BEPS recommendations.

Disappointingly, the discussion draft did not include a draft of the multilateral instrument itself, but it is expected to cover:

- a "minimum standard on treaty abuse" (either a limitation of benefits clause or principal purpose test);
- clarification of a State's right to tax its own residents;
- rules on resolving residency where an entity is resident in both jurisdictions;
- treaty shopping using third-country PEs;
- a new definition of a dependent agent permanent establishment and measures to address the artificial splitting-up of contracts to prevent a permanent establishment arising;
- minimum standards and best practices in relation to treaty-related dispute resolution.

It is intended that the multilateral instrument will be finalised and ready for signature by 31 December: we look forward to seeing the first draft!

ECOFIN reaches agreement on ATAD (the EU's Anti-Tax Avoidance Directive)

The Ministers of the EC and Financial Affairs Council reached final agreement on 21 June on the text of ATAD. ATAD represents, in-part, the EU level adoption of certain aspects of BEPS and will apply to all corporation tax payers in Member States. ATAD provides common minimum standards for EU Member States in a number of areas, including limiting interest deductibility (broadly limited to 30% of EBITDA, but with more generous carve-outs – including grandfathering – than the UK's proposals), CFC rules and limited, intra-EU hybrid rules. It also includes some non-BEPS inspired measures such as a provision on exit taxation and a general anti-abuse rule.

ATAD represents an unprecedented foray into Member State taxation by the EU. ATAD will now be submitted through the Committee of Permanent Representatives to the Council for formal approval. It will be required to be adopted in the national laws of Member States by 31 December 2018 to take effect as of 1 January 2019. Derogations apply to the provisions on interest deductibility and exit taxation. The exit taxation rule should be adopted into national laws by 31 December 2019 and take effect as of 1 January 2020. As for interest deductibility - Member States with national targeted rules for preventing BEPS risk may continue to apply those rules until the OECD reaches agreement on a minimum standard, but at the latest until January 2024.

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