Briefing

International review for May

Speed read

Cooperative compliance programmes are becoming increasingly en vogue: the early signs are that HMRC's profit diversion compliance facility has been a success; and Italy has introduced a new cooperative compliance programme for ascertaining permanent establishment (PE) status targeted at large multinationals. The Crown dependencies have jointly issued long-awaited draft guidance notes on the economic substance requirements which came into force from the beginning of 2019. The latest incarnation of Swiss tax reform passed a public vote and will come into effect from 1 January 2020. A public consultation has begun on proposed amendments to the profit attribution rules for PEs in India. France and the Czech Republic have continued to drive forward with unilateral measures on digital taxation.

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UK's profit diversion compliance facility

As explained in my international review for January, HMRC has introduced a profit diversion compliance facility (PDCF) to encourage taxpayers not already under investigation to review and update their transfer pricing policies and international arrangements. Some taxpayers considered 'high risk' received a 'nudge' letter encouraging them to register for the PDCF or risk an HMRC investigation but others can expect to be investigated without being nudged first.

HMRC's first batch of 'nudge' letters was issued at the end of January and allowed a 90 day grace period before HMRC may investigate. This grace period has therefore recently expired, and we understand that a large proportion of the 20 plus multinational groups (MNEs) that received a nudge in January are choosing to register. Whilst there are some common themes (e.g. MNEs with Swiss principal models and regional management functions in the UK), the MNEs concerned have varied in terms of their size and the industry they operate in. Early signs are therefore that the PDCF initiative has been a success for HMRC. Given this, the timing of HMRC's investigation of those that do not register may be accelerated.

Italian cooperative compliance programme for PE status

The Italian tax authorities (ITA) recently issued the implementing provisions for the cooperative compliance programme aimed at ascertaining the existence of PEs. Large multinationals which engage in direct sales in Italy are now allowed to file a specific ruling request to determine, in an open discussion with the ITA, whether their activities amount to a PE in Italy or not. Where a PE is determined to exist and the procedure is successfully completed, the non-resident entity should achieve certainty on the profit attributable to the PE (for corporate income tax and VAT purposes), be discharged from criminal penalties related to the failure to submit the tax return, and enjoy a penalty reduction of up to a sixth of the ordinary rate.

The request for such rulings is to follow a prescribed format set out on the website of the ITA and the ruling process is only available to non-resident entities which are not already under audit for an undisclosed PE in Italy and which pass certain turnover based thresholds for the group as a whole and for the value of supplies of goods or services in Italy.

Economic substance requirements in Crown dependencies

In response to being 'grey listed' by the EU, the Crown dependencies of Jersey, Guernsey and the Isle of Man (CDs) passed new legislation in December 2018 introducing economic substance requirements. The substance requirements are effective from 1 January 2019, and they apply to companies which are tax resident in a CD and have gross income from a relevant sector.

Earlier this month, the CDs jointly issued draft guidance notes in respect of the economic substance requirements. Whilst the guidance notes are not as detailed as many had expected, they do establish some useful principles that will assist affected companies in determining their compliance with the new requirements. The most substantive requirements are that the company must conduct the core income generating activity (CIGA) pertaining to the income it generates on the relevant island and its activities must also be 'directed and managed' on the island.

For a number of relevant sectors, there is specific guidance as to what activities would be considered as CIGA and examples of situations where the requirements would be met and where they would not. The examples themselves are quite simplistic and, as you might expect, at opposite ends of the spectrum but they are helpful nonetheless. There are some gaps, as no specific guidance and examples were included for insurance, shipping and intellectual property holding activity types. Points of interest include the acceptance of outsourcing, provided there is evidence of adequate supervisory functions being performed on the island; the potential to include outsourced activities performed on the island to satisfy the requirements; and the inclusion of directors and persons deemed employees under the laws of the relevant CD when determining if the company has an adequate number of qualified employees.

The sanctions for failure to comply include the exchange of information with other competent tax authorities, financial penalties and ultimately companies being struck off the companies register. There are also additional reporting requirements for relevant companies as part of the income tax return filing process.

The guidance is described as a work in progress and we expect it to be developed through further discussions with the OECD Forum on Harmful Tax Practices and the EU Code of Conduct Group. One area where the guidance could be improved is by addressing the subjectivity of some of the requirements; for example, the term 'adequate' is used in various places when referring to employees, physical presence, expenditure and supervision of outsourcing.

Swiss tax reform passes public vote

Switzerland is undertaking the most comprehensive reform of its corporate tax regime in the last 50 years, referred to as 'tax reform and AHV financing' (TRAF). The Swiss Parliament passed the legislation for TRAF on 28 September 2018, and on 19 May 2019 the Swiss tax reform passed its final hurdle when then Swiss population voted in favour of the measure in a binding public referendum.

The measures of the Swiss tax reform are expected to enter into force on 1 January 2020. Some of the highlights include a general lowering of cantonal/communal tax rates accompanied by minimum taxation at cantonal level; the abolition of privileged tax regimes perceived by the EU and OECD as harmful, including the mixed company, principal company and finance branch regimes; the introduction of internationally accepted tax incentives (e.g. patent box and R&D super-deductions); and a notional interest deduction in 'high tax' cantons (currently only expected to apply in Zurich). It is expected that after the TRAF is fully implemented, the majority of Swiss cantons will provide attractive effective income tax rates (i.e. combined communal/cantonal and federal) on pre-tax income between 12% and 22% before the application of any tax incentives.

Indian profit attribution rules for PEs

The Central Board of Direct Taxes (CBDT) has recently issued proposed amendments to the profit attribution rules for PEs in India for public consultation. The proposed profit attribution formulas and approach would be a significant departure from the functional analysis led authorised OECD approach followed by most countries. It essentially adopts a formulaic approach to arrive at profits derived by the Indian PE by multiplying the revenue from Indian customers by the global operating profit margin percentage and then apportioning this deemed global profit from Indian sales to the Indian PE based on a three-factor formula, assigning equal weights to sales, manpower and assets. In cases of profit attribution for entities with significant economic presence (SEP), the proposal recommends a four-factor formula wherein 'users' are considered as the fourth factor, with a weighting of 10% to 20%, depending on user intensity being low, medium or high. The CBDT also proposes a minimum floor rate margin of 2% on revenues derived from India to protect India's tax base in the case of companies having global operating losses. Finally, the proposal recommends relief from double taxation, to the extent that profits of any Indian subsidiary may already be taxed.

It is unclear how this apportionment approach would work in a treaty context but it should be noted that the Indian treaty network is based on the UN Model Convention. The authorised OECD approach to the attribution of profits to PEs is therefore not directly applicable, and article 7 of the UN Model Convention advocates that the profits of a PE should be attributed based on accounts maintained or determined by apportionment. If these changes are implemented in Indian domestic law in their current form and applied in treaty situations, the outcome is likely to be more uncertainty for taxpayers, increased litigation and a further increase in the already voluminous mutual agreement procedure (MAP) caseload of the Indian competent authorities.

Italy economic growth measures

A decree of 'urgent economic growth measures' was published in the official gazette on 30 April 2019 and is effective from 1 May 2019. The decree introduces a number of tax incentives effective immediately for fiscal year 2019, including a lower 22.5% rate of corporate income tax (IRES), which will be further reduced to 20.5% for fiscal year 2022, which applies to the extent profits are reinvested by the company and the net equity exceeds that are recorded in fiscal year 2018. Other measures include the reintroduction of the business combinations bonus amortisation and the bonus depreciation regime for investments in new tangible assets; an increase in deductibility of local real estate tax; and simplification of the patent box regime, allowing taxpayers to self-assess the benefit instead of having to obtain a tax ruling.

Greece and Cyprus

The Greek and Cypriot governments have recently approved changes to implement the EU Anti-Tax Avoidance Directive (ATAD), including introducing ATAD based interest limitation and CFC rules and a general anti-abuse rule.

USA

On 6 May 2019, the EU submitted comments concerning the proposed US federal regulations which were released in March 2019 and provide a deduction relating to foreign derived intangible income (FDII) and impose additional tax on global intangible low taxed income (GILTI). According to the EU letter, the FDII tax deduction is most likely a prohibited export subsidy under the WTO Agreement on Subsidies and Countervailing Measures, and is therefore in conflict with US treaty obligations.

Taxation of the digital economy

It has been a fairly quiet month in the UK as far as digital tax matters are concerned but there are a few international matters to update on. Firstly, we understand that the OECD's inclusive framework group is planning to release its next paper on the digitalisation of the economy and tax in advance of the next G20 meeting of finance ministers in Japan on 8 and 9 June. Ahead of that meeting, the EU finance ministers (ECOFIN) held a meeting on 17 May which addressed digital taxation. Following that meeting, the German finance minister Olaf Scholz indicated he expected the OECD to agree to a minimum level of taxation for large digital companies by the summer of 2020. He also said he expected progress by the third quarter of 2019 on introducing a financial transaction tax in at least nine EU countries.

In France, the Senate is debating the draft bill that would impose a 3% tax on digital giants that earn more than €750m in global digital revenue and at least €25m from digital sales in France. Under an amendment adopted by the Senate finance committee, the digital tax would be withdrawn by 1 January 2022 and further amendments could be made following the full Senate debate.

The Czech Ministry of Finance recently introduced its plan for a new digital services tax, which resembles those being discussed in the European Union. The Czech digital services tax is proposed to be imposed at a rate of 7% on revenues from targeted advertising on digital interfaces, the use of multilateral digital interfaces, and sales of data collected about users of digital services. The digital services tax would apply to these services when provided in the Czech Republic by companies with a global turnover of €750m or more. The proposed tax would also be based on a minimum turnover of these companies in the Czech Republic but that threshold has yet to be determined. The first draft of the legislation is expected by the end of May 2019 and could have an effective date from the middle of 2020. ■

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- The profit diversion compliance facility: a welcome opportunity or a trap to be avoided? (Steve Edge & Mike Lane, 17.3.219)
- Corporate residence and the economic substance requirements (Andrew Parkes & Zoe Wyatt, 7.2.19)
- OECD's digital economy tax reform: the race to consensus (Tom Roth, Kate Alexander & Allen Tan, 7.2.19)