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Global Tax **INSIGHT**

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An overview of this issue

We are delighted to introduce our first issue of Global Tax Insight, our biannual publication in which we cover key topical tax issues from around the globe. Its timing could not have been more propitious, following the UK's referendum vote to leave the European Union. This surprise result shook the European markets resulting in both dramatic movements in the FTSE 100 and other European exchanges, and volatility in the value of Sterling. Unfortunately the long term ramifications of the result are unclear and will depend on the outcome of government negotiations.

Any exit of the UK from the EU will undoubtedly have significant tax consequences. While it is therefore advisable for businesses to begin the process of assessing the potential ramifications and risks the referendum decision may have, it is our view that given the existing political uncertainties, it is still too early to provide any detailed commentary regarding its impact upon the tax landscape and we have therefore chosen not to address this in our first edition. However, our overview of the wider impact of Brexit and the process which will be followed can be found at www.ashurst.com/leapoffaith.

We hope that you find Global Tax Insight useful and enjoy reading this issue. If you have any feedback or if there are any topics that you would like us to cover in future editions, please email globaltaxinsight@ashurst.com.

We take a look at the following tax developments which have arisen around the globe:

UK Taxation of Fund Managers
The Finance Bill 2016 saw the inclusion of further changes which impact on the taxation of individuals within the UK's asset management industry. This article analyses how these changes impact fund managers.

New UK Tax Compliance Requirements for Large Businesses Part I: UK Tax Strategy
As part of a package of measures to try and promote low-risk behaviour and to increase tax transparency, businesses are now required to publish an online UK tax strategy. This article examines how these rules apply to both UK and multinational businesses.

Qualifying Private Placements – UK withholding tax exemption in practice
On 1 January 2016 a new UK withholding tax exemption for qualifying private placements came into force. This article considers the impact of this new UK withholding tax exemption for non-UK lenders.

Spanish Court Denies Interest Deductions in Cross-Border Financing
The Spanish Court has denied a company interest deductions without undertaking any economic or functional analysis of the financing or of the debt leverage assumed by the company. This article reviews this landmark decision.

New 10% Australian Withholding Tax
A new 10 per cent Australian withholding tax may apply to the disposal proceeds of certain Australian real property. This article take us through this new regime.

EU state aid and tax rulings – the net widens
The European Commission is continuing to investigate whether favourable advance tax rulings constitute unlawful state aid. This article considers what can be taken away from the EU Commission decisions in the Belgian Excess Profit Rulings Regime, Fiat and Starbucks cases for businesses with similar advanced tax rulings. The Apple decision, announced just three days before we went to press, will be analysed more fully in a future article.

UK Residential Property
Seismic changes to the taxation of UK residential property have taken place amid a backlash against rising UK property prices. This article examines the complexities of the current SDLT regime in the context of UK residential property.

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UK

Taxation of Fund Managers

by Alexander Cox, Paul Miller and Alastair Ladkin

Individuals in the UK's asset management industry have been subject to three very significant tax changes in the last 18 months, including, most recently, the further changes to the taxation of carried interest in the Finance Bill 2016.

Key Points

- **Recent changes arguably represent the most seismic shift in the taxation of individual UK asset managers in the past 30 years.**
- **They apply across most asset classes.**
- **A general understanding of their scope is critical – and is likely to help shape the structure of carry, co-investment and perhaps even investment strategy.**

These changes are primarily intended to address the taxation of amounts arising to individuals in the asset management industry which are not otherwise subject to income tax, either as employment income (in the case of employees) or trading income (in the case of members of an LLP). The new rules address this by effectively:

a taxing all amounts arising to individuals from the funds they manage as trading income, save in respect of limited categories of co-investment and carried interest. On current rates, this results in an effective rate of tax of 47 per cent (45 per cent income tax and 2 per cent NICs) on amounts which may previously have benefited from a lower rate of tax, e.g. as a capital gain; and

b taxing carried interest, which is not regarded as trading income, at a minimum rate of 28 per cent.

APPLICATION OF THESE CHANGES

The changes apply to asset managers across all asset classes and, in principle, therefore, will need to be considered by managers of all forms of funds. There are two circumstances in which individuals may be more relaxed about their application:

i. where they already receive all amounts in respect of the funds they manage as employment income or trading income, as those amounts will already be subject to tax at the highest income tax rates, e.g. where those individuals do not have any equity or debt interest in the underlying funds; and

ii. where the funds they manage are not a collective investment scheme (CIS), e.g. many funds which are established as non-UK body corporates.

A significant number of individuals may not, therefore, be affected by the changes, either because the funds they manage are established as non-UK body corporates or because they have no equity interest in the fund.

The changes will, however, be of direct application to managers of funds which are established in the form of a typical PE style limited partnership, irrespective of the underlying asset class.

IMPLEMENTATION – A BRIEF HISTORY

The changes have been introduced in three instalments:

i. the disguised investment management fee rules (DIMF Rules), which apply to amounts arising to individuals on or after 6 April 2015;
ii. the basic carried interest rules (CI Rules), which apply to amounts arising to individuals on or after 8 July 2015; and
iii. the income-based carried interest rules (IBCI Rules), which apply to amounts arising to individuals on or after 6 April 2016;

in each case, largely irrespective of when the fund was established or investments were made. The DIMF Rules and CI Rules apply to asset managers irrespective of whether they are employees or not. Somewhat oddly, the IBCI Rules do not apply to employees and are mainly of relevance to LLP members.

DIMF rules

The DIMF Rules broadly tax all amounts arising to individuals from a CIS fund (other than defined categories of co-investment and carried interest) as trading income, i.e at 47 per cent. UK resident doms and non-doms are taxed in the same way under these rules.

Co-investment covers most normal co-investment arrangements, i.e. where individuals co-invest alongside and on the same terms as investors, subject to management fee and carried interest waiver, but may not cover other types of more structured co-investment arrangements, e.g. arrangements involving leverage.

Carried interest generally includes only carried interest which is profit-dependent and subject to significant risk, or carried interest which is subject to a preferred return of at least 6 per cent.

CI rules

Under the CI Rules, all carried interest (other than income-based carried interest – see below) is broadly treated as capital gain and subject to a minimum 28 per cent capital gains tax charge – notwithstanding a reduction in the headline rate of capital gains tax to 20 per cent for other assets. These rules operate in tandem with the existing carried interest rules, rather than replacing them, and so, to the extent that any carry payment is made out of dividend or interest income, the higher income tax rates of 38.1 per cent and 45 per cent will apply, with credit for any 28 per cent charge.

UK resident doms and non-doms are taxed slightly differently under these rules, in that a proportion of any capital gain deemed to arise to a non-dom from a non-UK investment will be regarded as a foreign chargeable gain and therefore eligible for the remittance basis to the extent that the relevant asset management services are performed from outside the UK. Non-doms may therefore wish to keep a record of how much time they spend working outside the UK on their funds.

IBCI rules

Under the IBCI Rules, carried interest which is income-based carried interest will be taxed as trading income under the

Payment type made to individual manager	Detail	Taxation	Treatment of doms v non-doms
Disguised management fee	Any payment to managers other than: (a) vanilla co-invest; and (b) carried interest which is: (i) subject to a preferred return of at least 6 per cent, or profit-dependent and there is a significant risk the carry won't arise; and (ii) not income-based carried interest	Income tax and NICs at a combined 47%	Equal treatment
Vanilla Co-Invest	Investments on similar terms to third party investors in the fund (and management fee and carry waivers can be ignored for these purposes)	Capital taxed at 20% Dividends taxed at 38.1% Interest taxed at 45%	Different treatment: the remittance basis may apply to non-doms in the normal way in respect of income and capital gains from non-UK investments
Carried Interest	Non–income-based carried interest Treated as capital rather than income No base cost shift	Minimum 28% CGT charge with potential higher charges of 38.1% or 45% if paid from interest or dividends respectively	Different treatment: the remittance basis may be available to non-doms on non-UK investments to the extent that services to the fund are provided by a non-dom from outside the UK
	Income-based carried interest	Income tax and NICs at a combined 47%	Equal treatment

DIMF Rules at 47 per cent. Again, UK resident doms and non-doms will be taxed in the same way in respect of income-based carried interest.

INCOME-BASED CARRIED INTEREST

The IBCI Rules take up over 20 pages of the Finance Bill 2016. The following paragraphs are not, therefore, intended to be an exhaustive guide to the new rules – rather a summary of some of the key features.

As noted above, employees are not within the scope of the IBCI Rules so the following is mainly of relevance to LLP members.

The general rule

The basic premise of the legislation is simple – carried interest arising to individuals (other than employees) will be regarded as income-based carried interest and taxed as trading income unless the average holding period of the investments of the fund by value is at least 40 months (assuming a whole-of-fund carry). A proportion of carried interest will be regarded as income-based carried interest if the average holding period is between 36 and 40 months:

Average holding period of relevant investments	Income-based carried interest proportion
Less than 36 months	100%
At least 36 months but less than 37 months	80%
At least 37 months but less than 38 months	60%
At least 38 months but less than 39 months	40%
At least 39 months but less than 40 months	20%
40 months or more	0%

Carried interest, for these purposes, follows the definition in the DIMF Rules. Carried interest which is not income-based carried interest will be taxed under the CI Rules set out above (which will thus result in lower tax rates being payable). If the carry is not whole-of-fund, the calculation will be done by reference to the average holding period of only those investments in respect of which the carry is to be determined. There is a separate regime entirely for direct lending funds.

The general rule – average holding period

The calculation of average holding periods is clearly critical to the determination of income-based carried interest and is broadly determined by reference to when amounts are invested and when the investments funded by those amounts are disposed of. Large investments, follow-ons, part disposals and syndications may therefore have a disproportionate effect on the average holding period of investments in a fund. Short-term investments may, however, in some circumstances be disregarded in the average holding period calculation.

HMRC recognise that using an average holding period rule can have a distortive effect where large investments, follow-ons, part disposals and syndications arise and supplemental rules have therefore been introduced which modify the calculation of the average holding period for certain types of fund, such as venture capital funds, real estate funds and controlling equity stake funds (each as defined in the legislation).

Supplemental rules – funds other than direct lending funds

There are supplemental rules for each of: (i) funds holding a significant interest; (ii) venture capital funds; (iii) significant equity stake funds; (iv) controlling equity stake funds; (v) real estate funds; (vi) funds of funds; and (vii) secondary funds. These supplemental rules all modify the calculation of the average holding period where the fund has a "relevant interest" in a trading company or the holding company of a trading group.

Generally this operates so that any follow-on investment made after the fund has acquired the "relevant interest" is backdated and deemed to occur at the time the "relevant interest" was acquired, and any part disposal made while the fund holds that "relevant interest" is deemed to be delayed and not made until the fund's holding dips below a certain threshold. This means that for as long as a fund qualifies as one of the funds listed at (i)-(vii) above, the holding period of investments is maximised in order to mitigate any distortions through follow-on acquisitions and part disposals.

For example, in the case of a significant equity stake fund, any follow-on investment made after the fund holds a "significant equity stake" in the investee company is deemed to have been made when the fund acquired that "significant equity stake", and any part disposal is deemed not to occur until the fund holds no more than 15 per cent in the investee company or certain other conditions in respect of directors are met.

Each of the funds listed at (i)-(vii) is defined in the legislation, and some of their main characteristics are set out below:

a **Funds Holding a Significant Interest**
A fund which holds more than 50 per cent of the ordinary share capital of the investee company and those shares carry an entitlement to more than 50 per cent of the voting rights, profits available for distribution and assets available for distribution on a winding-up (a Controlling Interest) has a 'Significant Interest'.
Any follow-on investment made after a Controlling Interest is acquired is backdated to when the Controlling Interest was acquired, and any part disposal made while the fund has a Controlling Interest is deemed to be delayed until the fund ceases to have a 40 per cent interest in the investee company.

b **Venture Capital Fund (VCF)**
In order for a fund to qualify as a VCF it must be reasonable to suppose, when the fund starts to invest, that over the investment period of the fund:
i at least two-thirds of the total value invested by the

fund will be invested in "venture capital investments", i.e. unlisted newly issued shares or securities convertible into shares, the company uses the money invested for growth or to develop new products or services and the fund is entitled to appoint a director; and

ii at least two-thirds of the total value invested by the fund will be invested in investments held for 40 months or more.

In order for a VCF to benefit from the deemed holding provisions of the supplemental rules, the "relevant interest" which a VCF must hold is either at least a 5 per cent interest in the company or "venture capital investments" in the company with a value of more than £1m. Any part disposal made by a VCF is deemed to be delayed until it disposes of more than 80 per cent of the greatest amount invested at any one time in the company for the purposes of that fund, or the conditions around the appointment of a director cease to apply.

c **Significant Equity Stake Fund (SES Fund)**

In order for a fund to qualify as a SES Fund it must not be a VCF and it must be reasonable to suppose, when the fund starts to invest, that over the investment period of the fund:

i more than 50 per cent of the total value of the fund invested will be invested in "significant equity stake investments", i.e. in companies which are unlisted at the time of investing and are likely to remain so, the fund has a 20 per cent interest in each of those companies and the fund is entitled to appoint a director; and

ii more than 50 per cent of that value will be invested in investments which are held for 40 months or more.

Where a fund is a significant equity stake fund, and has a significant equity stake investment, any follow-on acquisition is backdated to the time the significant equity stake investment was acquired, and any part disposal is deemed delayed until the fund ceases to have a 15 per cent interest in the company or the conditions around the appointment of a director cease to apply.

d **Real Estate Fund (RE Fund)**

In order to qualify as an RE fund, it must be reasonable to suppose, when the fund starts to invest, that over the investment period of the fund:

i more than 50 per cent of the total value invested by the fund will be invested in land; and

ii more than 50 per cent of the total value invested by the fund will be invested in investments held for 40 months or more.

Where an RE Fund holds a major interest in land (i.e. a freehold interest or a lease with a term (or remaining term) in excess of 21 years), any investment in that land after the major interest was acquired will be deemed to have been acquired when the major interest was acquired, and any investment in adjacent land will be treated as

part of the original land. The supplemental rules will cease to apply where the fund disposes of more than 50 per cent of the greatest value invested at any one time in the land.

Supplemental Rules – Direct Lending Funds

In respect of direct lending funds, the default position is that all carried interest constitutes income-based carried interest.

A direct lending fund is a fund which is not subject to one of the other fund regimes under these rules and in relation to which it is reasonable to suppose that, when investments cease to be made, more than 50 per cent of the investments made by the fund will have been direct loans.

A direct loan for these purposes is an advance of money to any person at interest or for any other return determined by reference to the time value of money and, importantly, includes any loan acquired by the fund (on syndication or in the secondary market) within 120 days of being made.

Generally, therefore, credit funds which intend to undertake direct lending will typically fall within these rules, whereas credit funds which intend to invest in the secondary market outside of the 120 days typically will not. Credit funds which take equity stakes as part of their investment strategy may fall within one of the other fund regimes and should consider their position carefully.

The Exception for Direct Lending Funds

The presumption that carried interest in respect of a direct lending fund is income-based carried interest is disapplied where:

a the fund is a limited partnership (or equivalent formed outside the UK);

b the carried interest is subject to a preferred return of at least 4 per cent; and

c it is reasonable to suppose that, when investments cease to be made, at least 75 per cent of the direct loans (calculated by reference to value) will have been qualifying loans.

Qualifying loans are arm's-length loans made to unconnected borrowers with fixed and determinable repayments, a fixed maturity and a relevant term of at least four years (the relevant term is the period from when money is advanced until the time by which at least 75 per cent of the principal must be repaid under the terms of the loan). The fund must also have the intention to hold the qualifying loan to maturity.

Many direct lending funds are now being established as limited partnerships and, in principle, therefore, will be able to benefit from this exception. The requirement that at least 75 per cent of the investments of the fund need to have been qualifying loans may present difficulties where the fund expects to syndicate some or all of its loans, however, because in order to be a qualifying loan the fund must intend to hold it to maturity. Any syndication policy should therefore be considered very carefully by any direct lending fund which hopes to fall within the exception.

Where a fund falls within the exception, the extent to which any carried interest in respect of that fund constitutes income-based carried interest will be determined by the general rule, i.e. by reference to the average holding period of the investments in the fund.

Syndication

In light of the average holding period rule, any syndication strategy needs to be considered very carefully. Certain part disposals/syndications can be disregarded where, among other things, the "unwanted investment" is disposed of within 120 days of acquisition and does not constitute more than half of the original investment, but we recommend that, at least initially, this is reviewed on a case-by-case basis.

Early Repayment of Principal

The early repayment of loans may also have a disproportionate effect on average holding periods. In recognition of this, the IBCI Rules provide that, in the context of a direct lending fund, where the principal amount of a qualifying loan (see above) is repaid within 40 months of the loan being made, the whole loan will generally be deemed to have been held for 40 months provided it is reasonable to suppose that the borrower's repayment was not concerned with the application of these rules. This deeming provision is, however, limited to qualifying loans only.

CONCLUSION

Application

Individuals managing funds which are established as collective investment schemes (e.g. limited partnerships and open-ended fund vehicles) are likely to be affected by some or all of the rules described above.

In analysing their position, the starting point is that they should expect to pay tax at 47 per cent on all amounts arising to them from those funds which are not otherwise subject to employment or trading income taxes, except to the extent that those amounts represent returns on a vanilla co-investment or carried interest which is profit-dependent and subject to significant risk or subject to a 6 per cent preferred return.

In addition, those individuals who are not employees will then also need to consider whether any carried interest arising to them (which is not otherwise taxed at 47 per cent) is income-based carried interest and therefore also subject to tax at 47 per cent. This will depend on whether the fund is a direct lending fund and, if it is not a direct lending fund or falls within the exception for direct lending funds, on the average holding period of investments in the fund.

In either case, carried interest which escapes the 47 per cent charges above will be subject to a minimum 28 per cent capital gains tax charge. If the carried interest is entirely funded out of capital or capital gains, there is no further UK tax to pay. However, there will be additional tax to pay at the appropriate dividend and interest rates if the carry is funded out of income.

Finally, non-doms may benefit from the remittance rules in respect of part of their carried interest under these rules if it relates to a non-UK investment and the individual performs some or all of their services outside the UK.

Practical Points

The application of some of the rules set out above depends in part on the investment strategy and profile of the fund. It may therefore be sensible to include reference, where appropriate, to anticipated holding periods in prospectuses and information memoranda.

Syndication strategies, follow-on investments and part disposals should all be considered very carefully because this could have a disproportionate effect on the average holding period of investments in the fund.

Direct lending funds which intend to take advantage of the exception to the default position on direct lending funds should ensure that 75 per cent of their loans will meet the qualifying loan test.

None of these sets of rules impose employers' NICs. Thus, even where the above rules apply, it may still be worthwhile for employers to give equity interests to employees rather than pay them bonuses.

Non-doms may wish to record time worked outside the UK on their funds to benefit from the remittance basis under the carried interest rules.

Finally, any fund managers should approach any structuring around these rules with caution; there are targeted anti-avoidance rules in each of these regimes and the current environment is not at all sympathetic to what might be perceived as aggressive tax planning.

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UK

New Tax Compliance Requirements for Large Businesses

Part I: UK Tax Strategy

by Nicholas Gardner and Caroline Page

Large businesses are the target of a further package of measures in an attempt to close the UK tax gap through promoting low-risk behaviour and increasing tax transparency.

These measures comprise the publication of an online UK tax strategy (Tax Strategy), sanctions for businesses who are "persistently" unco-operative with HMRC and a framework for co-operative compliance. HMRC considers that these measures will reduce aggressive tax planning and failure to engage with HMRC, and they are the latest in the chain of anti-avoidance measures being introduced. In this Part I we examine the UK Tax Strategy.

Key Points

- **Many UK businesses must, for financial years commencing on or after Royal Assent of Finance Bill 2016, publish a publicly available and free online Tax Strategy on their websites.**
- **A Tax Strategy must address UK tax risk management, UK tax governance, UK tax planning, the business's approach to risk taking in respect of UK tax and its relationship with HMRC.**
- **Non-compliance with the requirement to publish a Tax Strategy will attract penalties. Breaches of a published Tax Strategy may give rise to reputational issues and risk of action by shareholders.**

Key Definitions

"**Foreign Group**" means a Group whose head is a body corporate (excluding UK LLPs) incorporated outside the UK.

A "**Group**" means two or more bodies corporate (excluding LLPs), wherever incorporated, which together constitute:

a an MNE Group; or
b a Group other than an MNE Group.

A "**Group other than an MNE Group**" means a Group consisting of two or more bodies corporate which contains at least two UK incorporated companies but which is not an MNE Group.

A Group is "**headed**" by whichever body corporate (excluding LLPs) within the Group is not a 51 per cent subsidiary of another member of the Group.

"**MNE Group**" is defined by reference to the OECD model legislation for the Country-By-Country reporting package as follows:
"MNE Group" means any Group that includes two or more enterprises the tax residence for which is in different jurisdictions, or includes an enterprise that is resident for tax purposes in one jurisdiction.

"**Qualifying Company**" means:

a a solus UK incorporated company with a turnover of more than £200m and/or a balance sheet total of more than £2bn; or
b a UK incorporated member of a Foreign Group which is a Qualifying Group and which is not a member of a UK Sub-Group.

"**Qualifying Group**" means:

a if the Group is an MNE Group, a Group with a total consolidated group revenue of €750m or more (or the equivalent in any other currency in which the MNE Group's Consolidated Financial Accounts are drawn up at the average exchange rate for the accounting period); and
b in the case of a Group other than an MNE Group, a Group with an aggregate turnover of UK incorporated group members of more than £200m and/or an aggregate balance sheet of UK incorporated group members of more than £2bn.

"**Qualifying Partnership**" means a UK Partnership with a turnover of more than £200m and/or a balance sheet total of more than £2bn.

"**UK Group**" means a Group whose head is a body corporate (excluding LLPs) incorporated in the UK.

"**UK Partnership**" means a body carrying on a trade, business or profession with a view to profit which is a general partnership, an English or Scottish limited partnership or a UK Limited Liability Partnership.

"**UK Sub-Group**" means two or more relevant bodies that would be a UK Group but for their membership of a Foreign Group.

Who must prepare and publish a Tax Strategy?

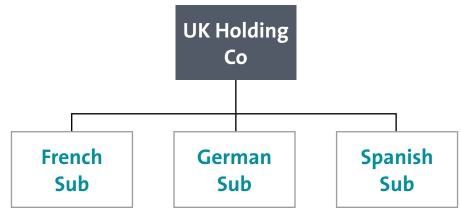
It is the responsibility of the head of a Qualifying UK Group, the head of a UK Sub-Group of a Qualifying Foreign Group, a Qualifying Company and a UK Qualifying Partnership to prepare and publish a Tax Strategy (see Key Definitions box). A group is either UK or Foreign depending on whether the head of that group is incorporated in the UK or elsewhere, respectively.

We discuss below, with examples, how the rules apply to different corporate structures.

1. **Qualifying UK Groups**
   If a UK Group is a Qualifying Group, the head of the Group must ensure that the Tax Strategy relating to the UK Group's approach to UK taxation is prepared and published. Any of the UK companies that are members of the group must publish the Tax Strategy. This will be relevant to all Qualifying Groups headed by a UK company.
2. **Foreign Qualifying Groups**
   If a Foreign Group which is a Qualifying Group contains a UK Sub-Group, the head of the UK Sub-Group must ensure that the Tax Strategy relating to the UK Sub-Group's approach to UK taxation is prepared and published. Any of the UK companies that are members of the UK Sub-Group must publish the Tax Strategy. This will apply to an MNE Group which is a Foreign Group that contains a UK holding company even if there are no other UK companies in the Group, and to all other groups of companies with two or more UK companies forming a sub group if they satisfy the turnover tests.
3. **UK Companies and Partnerships (including LLPs)**
   If a company or partnership is a Qualifying Company or a Qualifying Partnership, that company or partnership must prepare and publish the Tax Strategy relating to its approach to UK taxation.
   For clarity, a UK incorporated company within a UK Group or UK Sub-Group falls within the rules for qualifying UK groups or foreign qualifying UK groups above.
4. **UK Permanent Establishments**
   A UK permanent establishment of a non-UK incorporated company is classified as a UK incorporated company for these purposes and is to be treated accordingly.

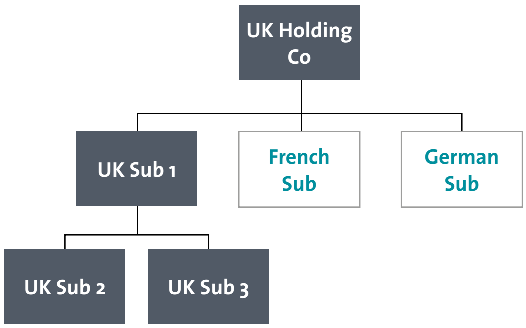
Examples of when a Tax Strategy may be required

UK-Headed Group with Foreign Subsidiaries



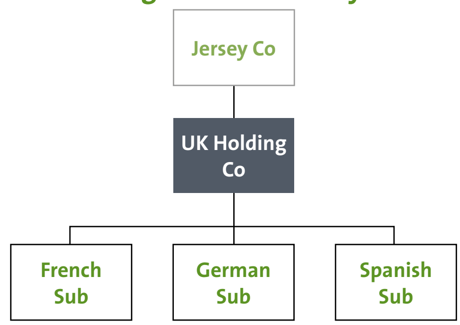
1 Is there a UK Group which is a Qualifying Group?
Yes – if the Group is an MNE Group.
Commentary and conditions
The head of the group is a UK incorporated company making this a UK Group. This may be a Qualifying UK Group if it is an MNE Group (i.e. the group has a total consolidated group revenue of €750 or more). The group cannot be a Group other than an MNE Group as the group only contains one UK incorporated company.
Tax Strategy Position
If this is a UK Qualifying Group, UK Holding Co must prepare and publish its own Tax Strategy.
2 Is there a UK Sub-Group which is part of a Foreign Group which is a Qualifying Group?
No
Commentary and conditions
There is no UK Sub-Group.
Tax Strategy Position
N/A
3 Is there a Qualifying Company?
Yes – if the Group is not an MNE Group and UK Holding Co has a turnover of more than £200m and/or a balance sheet of more than £2bn.
Commentary and conditions
If UK Holding Co is not a member of a UK Group, it will be a Qualifying Company if it has a turnover of more than £200m and/or a balance sheet total or more than £2bn.
Tax Strategy Position
If this is a Qualifying Company, UK Holding Company must publish its own Tax Strategy.

UK-Headed Group with UK and Foreign Subsidiaries



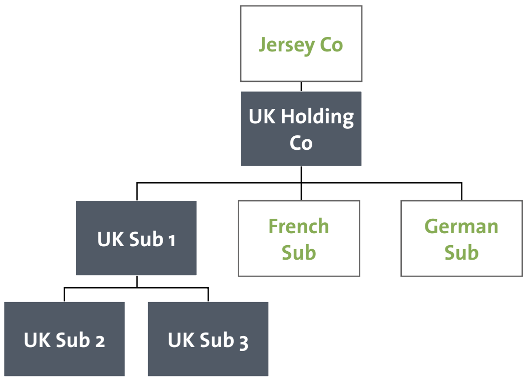
1 Is there a UK Group which is a Qualifying Group?
Yes – if the conditions below are satisfied.
Commentary and conditions
The head of the group is a UK incorporated company making this a UK Group. This may be a Qualifying Group if: (a) the group is an MNE Group (i.e. the group has a total consolidated group revenue of €750 or more); or (b) the group is a Group other than an MNE Group (i.e. it has an aggregate UK turnover of more than £200m and/or an aggregate UK balance sheet of more than £2bn).
Tax Strategy Position
If this is a Qualifying Group, UK Holding Co must ensure that a Tax Strategy in respect of all of the UK companies is prepared and published. Any of the UK companies must publish the Tax Strategy.
2 Is there a UK Sub-Group which is part of a Foreign Group which is a Qualifying Group?
No
Commentary and conditions
There is no UK Sub-Group.
Tax Strategy Position
N/A
3 Is there a Qualifying Company?
No
Commentary and conditions
All of the UK Companies are part of a UK Group and therefore there is no individual Qualifying Company.
Tax Strategy Position
N/A

Foreign-Headed Group with single UK Subsidiary



1 Is there a UK Group which is a Qualifying Group?
No
Commentary and conditions
The head of the group is a non-UK incorporated company.
Tax Strategy Position
N/A
2 Is there a UK Sub-Group which is part of a Foreign Group which is a Qualifying Group?
No
Commentary and conditions
There is no UK Sub-Group.
Tax Strategy Position
N/A
3 Is there a Qualifying Company?
Yes – if the conditions below are satisfied.
Commentary and conditions
UK Holding Co may be a Qualifying Company if: (a) the group is an MNE Group (i.e. the group has a total consolidated group revenue of €750 or more); or (b) it has a UK turnover of more than £200m and/or a UK balance sheet of more than £2bn.
Tax Strategy Position
If UK Holding Co is a Qualifying Company, it must prepare and publish its own Tax Strategy.

Foreign-Headed Group with multiple UK and Foreign Subsidiaries



1 Is there a UK Group which is a Qualifying Group?

No

Commentary and conditions

The head of the group is a non-UK incorporated company.

Tax Strategy Position

N/A

2 Is there a UK Sub-Group which is part of a Foreign Group which is a Qualifying Group?

Yes – if the conditions below are satisfied.

Commentary and conditions

UK Holding Company is the head of the UK Sub-Group comprising UK Holding Co, UK Sub 1, UK Sub 2 and UK Sub 3. This may be a Qualifying Group if:
(a) the group is an MNE Group (i.e. the group has a total consolidated group revenue of €750 or more); or
(b) the group is a Group other than an MNE Group and the UK Sub-Group has an aggregate UK turnover of more than £200m and/or an aggregate UK balance sheet of more than £2bn.

Tax Strategy Position

If this is a Qualifying Group, UK Holding Co must ensure that a Tax Strategy in respect of all of the UK Sub-Group is prepared and published.
Any of the UK companies in the UK Sub-Group must publish the Tax Strategy.

3 Is there a Qualifying Company?

No

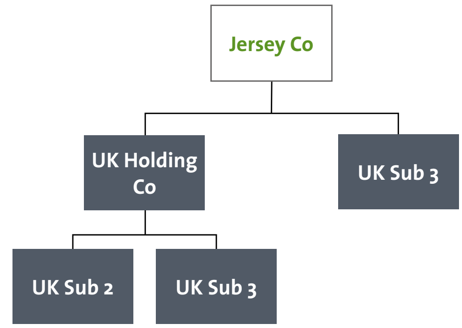
Commentary and conditions

There is no Qualifying Company because each UK company is a member of the UK Sub-Group.

Tax Strategy Position

N/A

Foreign-Headed Group with UK Sub-Group and UK Subsidiary



1 Is there a UK Group which is a Qualifying Group?

No

Commentary and conditions

The head of the group is a non-UK incorporated Company.

Tax Strategy Position

N/A

2 Is there a UK Sub-Group which is part of a Foreign Group which is a Qualifying Group?

Yes – if the conditions below are satisfied.

Commentary and conditions

UK Holding Co is the head of the UK Sub-Group comprising UK Holding Co, UK Sub 1 and UK Sub 2.
This may be a Qualifying Group if:
(a) the group is an MNE Group (i.e. the group has a total consolidated group revenue of €750 or more); or
(b) the group is a Group other than an MNE Group and the aggregate UK turnover of all of the UK Sub-Group is more than £200m and/or the aggregate UK balance sheet of all of the UK Sub-Group is more than £2bn.

Tax Strategy Position

If this is a Qualifying Group, UK Holding Co must ensure that a Tax Strategy in respect of all of the UK Sub-Group Companies is prepared and published. Any of the UK Sub-Group companies must publish the Tax Strategy.

3 Is there a Qualifying Company?

Yes – if the conditions below are satisfied.

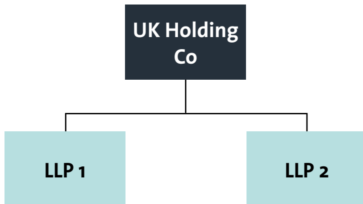
Commentary and conditions

UK Sub 3 may be a Qualifying Company if:
(a) the group is an MNE Group (i.e. the group has a total consolidated group revenue of €750 or more); or
(b) it has a UK turnover of more than £200m and/or a UK balance sheet of more than £2bn.

Tax Strategy Position

If UK Sub 3 is a Qualifying Company, it must prepare and publish its own Tax Strategy.

UK-Headed Group with LLPs



1 Is there a UK Group which is a Qualifying Group?
No
Commentary and conditions
There is no UK Group as LLPs are not included in the definition of Group.
Tax Strategy Position
N/A
2 Is there a UK Sub-Group which is part of a Foreign Group which is a Qualifying Group?
No
Commentary and conditions
There is no UK Sub-Group.
Tax Strategy Position
N/A
3 Is there a Qualifying Company?
Yes – if the conditions below are satisfied.
Commentary and conditions
UK Holding Co may be a Qualifying Company if it has a UK turnover of more than £200m and/or a UK balance sheet of more than £2bn.
Tax Strategy Position
If UK Holding Co is a Qualifying Company, it must prepare and publish its own Tax Strategy.
4 Is there a Qualifying Partnership?
Yes – if the conditions below are satisfied.
Commentary and conditions
Each of LLP1 and LLP2 may be a Qualifying Partnership if its partnership turnover is more than £200m and/or its partnership balance sheet total is more than £2bn.
Tax Strategy Position
Each of LLP1 and LLP2 must prepare and publish its own Tax Strategy if it is a Qualifying Partnership.

As can be seen, rather confusingly, the rules apply differently depending upon the entity concerned and the corporate group structure in place. This results in some anomalies, most notably that a group can qualify as a Qualifying Group (UK or Foreign) if it is an MNE and only has one UK incorporated company in its structure, but can only qualify as a non-MNE Qualifying Group if there are at least two UK incorporated companies. It is a shame that the rules were not simply drafted as a requirement to produce a Tax Strategy if the UK operations exceeded the relevant financial thresholds.

It should also be noted that UK incorporated companies are UK companies for this purpose irrespective of the location of their activities and the financial tests will be applied by reference to their activities worldwide. However, a foreign company with UK and foreign branches is only treated as a UK company for these purposes in respect of its UK branch, leaving the foreign activities out of the financial qualifications. There is no obvious rationale for this result.

The Tax Strategy must address:

- the approach of the business to risk management and governance arrangements in relation to UK taxation;
- the attitude of the business towards tax planning (in so far as it affects UK taxation);
- the level of risk the business is prepared to accept in relation to UK taxation; and
- the business's approach to its dealings with HMRC. (paragraph 17(1) of schedule 19, Finance Bill 2016).

The Tax Strategy must also make clear that its publication satisfies the business's duty to publish a Tax Strategy in accordance with the legislative framework. No supporting factual information is required to be published.

Content of the Tax Strategy

While many businesses already include some narrative in respect of their tax policies in their annual report or other publicly available documentation, we would anticipate that even those businesses which follow the Confederation of British Industry's (CBI) seven tax principles or who are members of the Extractive Industries Transparency Initiative (EITI) will most probably need to include additional information to satisfy the requirements of the Tax Strategy. HMRC has helpfully published draft high-level guidance on the content of a Tax Strategy which can be found here: https://www.gov.uk/guidance/large-businesses-publish-your-tax-strategy. HMRC will assess a business against its Tax Strategy and we would therefore expect businesses to take a cautious approach to early Tax Strategies by not making them unduly onerous and consequently for these to be short and to the point. This approach may change over time as businesses are able to review other Tax Strategies and once HMRC's practice of enforcing compliance with the strategy becomes clearer. Please see the box below for an overview of the contents of a Tax Strategy.

Outline Contents of a Tax Strategy

Tax risk management and tax governance

- Who designs and has ownership of the Tax Strategy
- What policies, procedures and governance frameworks are in place in respect of tax risk and which support the Tax Strategy
- The role of the board, financial director, chief financial officer and/or audit committee in respect of the Tax Strategy
- The level of oversight of the Tax Strategy

Tax Planning

- Compliance with arm's length and other OECD principles
- Approach to tax incentives and exemptions
- The drivers behind and approach to the structuring of tax planning
- Whether tax is paid where profits are earned
- Whether there are any artificial tax arrangements in place
- Whether any code of conduct is followed

Risk Taking

- Any risk rating allocated to the business by HMRC
- How prescriptive the board/financial director/chief financial officer/audit committee is in respect of what is an acceptable level of risk to take

Relationship with HMRC

- How transparent, open, and/or compliant the business's relationship with HMRC is
- How proactive the business is in relation to tax disputes and how prompt the business is in disclosing matters to HMRC
- How the business works with HMRC to meet statutory requirements

Confirmation that the Tax Strategy is compliant with HMRC's requirements

Putting together a Tax Strategy and Board Involvement

While any tax team should be well placed to put together a Tax Strategy, a business should consider obtaining board approval of the Tax Strategy as part of its governance function. Although HMRC has previously remarked that it believes that the board as a whole is responsible for a Tax Strategy as part of a business's corporate governance process, there is no legislative requirement to obtain board approval.

HMRC's use of the Tax Strategy

HMRC intends to use a business's Tax Strategy to help it determine the level of risk it should allocate to that business. The Tax Strategy may therefore influence the level of scrutiny a business is under from HMRC. However, if businesses adopt similar Tax Strategies, this may not be very significant.

Timing of Publication of Tax Strategy

Businesses should have until at least summer 2017 to publish their first Tax Strategy as a business's first Tax Strategy need not be published until the end of the business's first financial year starting on or after Royal Assent of the Finance Bill 2016 where the business has satisfied the financial tests in the previous financial year. Royal Assent of the Finance Bill 2016 is not expected before the end of summer 2016. Going forwards, if applicable, a business has 15 months from the date of publication of its previous Tax Strategy to publish its next Tax Strategy.

The Tax Strategy must remain published for at least one year or until the Tax Strategy for the following year is published, if earlier. A Tax Strategy is treated as published once it is available on the internet.

Penalties

An appealable penalty of £7,500 may arise:

- if a business fails to publish a Tax Strategy containing the required information within the prescribed time or fails to ensure that the Tax Strategy is publicly available for the prescribed time;
- if a business still has not published a Tax Strategy containing the required information six months after it was due to be published; and
- for every month thereafter in which a Tax Strategy should have, but has not, been published.

HMRC must notify a business if it is to assess a penalty, and the business has 30 days from the receipt of notification of a penalty assessment to appeal that penalty in writing. There are no statutory penalties for a business failing to follow its Tax Strategy or for a Tax Strategy not reflecting the inner workings of a business. However, as mentioned above, HMRC will be using the Tax Strategy to evaluate risk, and therefore to deviate from a Tax Strategy could result in a business being subject to increased scrutiny from HMRC. There are also reputational issues which could arise and a risk of legal action from shareholders if a business's Tax Strategy deviates materially from its actual internal workings and policies.

Notification of Publication of Tax Strategy

While there is no legislative requirement to notify HMRC of publication of a Tax Strategy, as HMRC will be scrutinising whether a Tax Strategy is published and continues to be published within the statutory time frames, it may be prudent to notify HMRC once a Tax Strategy is published.

Changes to the original Tax Strategy proposal

The Government originally proposed that:

a a named individual should be accountable for a business's Tax Strategy; and

b the Tax Strategy should include the target effective tax rate (ETR) of the business and the measures taken to reach this target.

These proposals were criticised during the consultation process and have been dropped. Multinational groups are unlikely to have an ETR relating to the UK business alone and this would have caused difficulty in practice.

Looking forward

While businesses have at least a year before their first Tax Strategy is required to be published, we recommend setting the governance wheels in motion sooner rather than later. Also, while HMRC guidance may be updated, the scope of the legislation is more or less determined and now would be an opportune time to start producing an initial draft of the Tax Strategy.

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UK

Qualifying private placements – UK withholding tax exemption in practice

by Paul Miller and Caroline Page

The UK's new interest withholding tax exemption for qualifying private placements (QPP Exemption) came into force on 1 January 2016.

One major impact of the QPP Exemption is that lenders in China, Indonesia, Italy, Japan, Korea, Malaysia, Mexico and New Zealand, among others, will now generally be able to lend to UK borrowers without suffering any UK withholding tax. Previously, they incurred UK withholding tax if the debt was not lent out of a UK branch or structured as a quoted Eurobond.

This article examines the QPP Exemption and its application in practice, and considers the Loan Market Association's (LMA) recently released drafting in respect of the QPP Exemption.

Background to private placements

Private placements are much more common in the US than is currently the case in Europe.

There is a widely held view that the depth and resilience of the US private placement market helped speed up economic recovery, as lenders other than traditional banks stepped in to fill the funding gap as banks shrank their balance sheets. This has led to a well-publicised effort to develop a pan-European private placement market.

A typical private placement involves direct lending by non-bank investors, such as pension funds, insurers and fund managers.

UK withholding tax position

Generally the UK imposes a 20 per cent withholding tax (WHT) on payments of interest by UK incorporated companies (and some foreign companies with a UK connection) on loans or debt securities where the loan or debt is intended to last at least a year.

Historically, the UK has had a number of domestic exemptions from this WHT. Most UK lenders that are either incorporated as a company or registered as a pension fund with HMRC can therefore receive payments of interest gross. However, the position for non-bank lenders – the category of lenders the QPP Exemption is designed to stimulate – has been more difficult where they are incorporated outside the UK. Even the quoted Eurobond exemption, which disapplies WHT from most listed bonds, does not generally apply to private placements of debt securities issued by UK-incorporated companies, since such issuances are usually unlisted.

Where lenders could not use the above UK domestic exemptions, it did not necessarily prove fatal, as lenders resident in jurisdictions that have a double tax treaty with the UK, which reduces WHT to nil, could generally still apply to HMRC for exemption from WHT pursuant to such double tax treaties. Historically, this was a somewhat painful and time-consuming process, involving a formal tax treaty clearance application to HMRC for each loan. However, since 2010, HMRC has offered an alternative streamlined process, known as the double tax treaty passport scheme (DTTP), where eligible lenders can apply for a treaty passport to extend the nil WHT position to all loans with UK interest entered into by such lender across a five-year period. This process generally works well, provided that the necessary procedural formalities in relation to both borrower and lender are complied with, which can take a little time and paperwork. The new QPP Exemption is an addition to these exemptions.

Key Points

- **The QPP Exemption reduces UK interest withholding tax from 20 per cent to 0 per cent where the conditions are met.**
- **This is particularly helpful for lenders in China, Japan and Korea, among others, who previously would generally have suffered some withholding tax.**
- **Investors based in tax havens will generally not benefit from the QPP Exemption.**

QPP Exemption

The QPP Exemption is designed to simplify matters for lenders in treaty jurisdictions. However, it will not assist lenders incorporated in tax havens.

What are the conditions for the QPP exemption?

Two sets of conditions need to be met. The first of these, effectively the "gateway" to the QPP Exemption, is in section

888A Income Tax Act 2007 and provides that the QPP Exemption is, subject to the further conditions discussed below, available for:

- interest paid on a security;
- which represents a loan to which a company is a party as debtor; and
- which is not listed on a recognised stock exchange.

It is worth noting that:

a despite the reference to a "security", HMRC's stated view is that the exemption will be available for debt taking the form of loans, facility agreements, etc., as well as debt structured as notes or bonds;

b the exemption applies whether the debt is in bearer or registered form; and

c in theory, the exemption applies whether the debt is held through a clearing system or not and, if it is held though a clearing system, irrespective of the location of the clearing system (so long as it is not also listed on a recognised stock exchange). However, the certification required from each lender in order to qualify for the QPP Exemption (set out below) means that the exemption is currently less useful for instruments held through a clearing system.

Additional conditions in the regulations

The Qualifying Private Placement Regulations 2015 (SI 2002/2015) specify that the following three further sets of conditions must be met:

1. **Securities**
   - The securities must not have a term exceeding 50 years.
     There is no minimum term specified. As noted above though, where the term is less than a year (e.g. commercial paper), there is generally no UK WHT in any event.
   - The security, or the placement as a whole, must have a minimum value of £10m at the time it is entered into and it is worth noting that it is the "value" which is to be a minimum of £10m, meaning that non-sterling securities qualify for the QPP Exemption. HMRC has indicated that this £10m threshold will remain under review as the market develops.
   - There is no upper limit for the availability of the exemption.
2. **Debtor**
   The relevant conditions as follows:
   - The debtor generally has to be a corporate entity. This means that issues by unit trusts and partnerships will not qualify, although we understand that HMRC is considering the position of LLPs.
   - The debtor must reasonably believe that it is not connected to the creditor.
     This has presumably been included to prevent intra-group shareholder debt availing itself of this new exemption. That is not surprising given the historic discussions around shareholder debts structured as quoted Eurobonds.
   - The debtor must enter into the relevant security for genuine commercial reasons and not as part of a tax advantage scheme.
     This sort of provision is now fairly standard in new UK tax legislation.
3. **Creditor**
   The relevant conditions (Creditor Conditions) are as follows:
   - The creditor is "resident" in a "qualifying territory". This is the key condition around the scope of the QPP Exemption.

A "qualifying territory" is, broadly, the UK or a territory with which the UK has a double tax treaty with a non-discrimination provision. Importantly, it is not relevant whether the relevant double tax treaty reduces WHT to nil. The UK has tax treaties with a number of tax havens including the Cayman Islands, the British Virgin Islands, Guernsey and Jersey, and that sometimes causes confusion as to whether those territories count as a "qualifying territory". The point to note is that even where the UK does have a double tax treaty with a tax haven, such treaties do not generally have a "non-discrimination provision" (effectively, a clause providing that the UK shall not discriminate against nationals of the tax haven as compared to UK nationals). Consequently, the QPP Exemption will not directly assist lenders incorporated in such tax havens.

There is a (slightly dated) list of the treaties that HMRC considers are with "qualifying territories" in the HMRC International Manual at INTM412090.

The creditor must be "resident" in a qualifying territory and "resident" means "liable to tax" in that territory. Note that this condition means that such a lender would (subject to the below) often already be able to avail itself of relief from WHT under the relevant double tax treaty (assuming the relevant filings were made).

Turning then to how the residence concept applies to different lender entities:

1. **Foreign pension funds and charities**
   The UK will generally treat these entities as "resident" even if they are tax exempt in their home jurisdiction. If so, they should therefore be eligible for the QPP Exemption.
2. **Partnerships**
   In order to qualify as a "resident", the lender effectively needs to be a taxpayer in the relevant jurisdiction. Consequently, those partnerships which are treated as tax transparent will generally not, themselves, qualify. However, those partnerships which are treated as a company or taxed in the same way in their home jurisdiction (e.g. a Lux SCA) will generally qualify. On the face of it, therefore, the QPP Exemption will not directly help those widely held private equity, mezzanine, infrastructure or other funds which are set up as partnerships, whether in the UK or elsewhere.

We understand that the intention of the QPP Exemption is to look to the ultimate recipient of the interest, which, in this case, would mean looking through the partnership to the partners to see if they satisfy the Creditor Conditions for the QPP Exemption. While HMRC has informally indicated that it should be possible to look through a partnership, these views are unpublished.

We have seen some partnerships use the QPP Exemption where all the partners are resident in the UK or a "qualifying territory", though this has tended to be where the number of partners is small. There are a number of issues with this approach. First, there are questions concerning how the Creditor Certificates (see below) should be provided, particularly where there are carry arrangements. Secondly, not even the new LMA qualifying private placement loan documentation wording (see below) treats such a partnership as a "Qualifying Lender". Thirdly, some of HMRC's guidance on this point is unpublished. In short, this means that documenting deals for such partnerships is currently much more time-consuming than doing so for the more familiar sort of vehicles.

The QPP Exemption is currently more likely to assist partnerships where a fund partnership has incorporated a subsidiary entity, such as a taxable Luxembourg company. Indeed, this new exemption could be very useful if work under Action 6 of the OECD Base Erosion and Profit Shifting (BEPS) Plan restricts the ability of such subsidiaries to access treaty relief.

- The creditor is "beneficially entitled" to the interest for genuine commercial reasons and not as part of a tax advantage scheme.

"Beneficial entitlement" in this context should be given its UK domestic meaning and not the broader international fiscal meaning which it attracts in the context of double tax treaties following Indofood, whereby a beneficial owner must have full privilege to directly benefit from the interest. Under the UK domestic meaning, and pre-Indofood, mere back-to-back contractual arrangements were not considered to deprive an entity of beneficial ownership, and we would consider the same to be the case here.

However, as beneficial entitlement is coupled with the requirement for the creditor to not be part of a tax advantage scheme, consideration should be given to any arrangement that could be seen as constituting a conduit arrangement with a tax haven entity; for example, a total return swap or sub-participation.

Procedural formalities

A creditor is required to confirm by producing a certificate (a Creditor Certificate) that it meets the two Creditor Conditions, and once the borrower has received that Creditor Certificate it can rely on the QPP Exemption.

There is no prescribed format in the legislation for a Creditor Certificate. The LMA has produced a form of Creditor Certificate which is scheduled to the new LMA qualifying private placement document.

While it is a condition of the QPP Exemption that the debtor holds a Creditor Certificate, the QPP Exemption does not expressly require that the Creditor Conditions (at (3) above) are satisfied at the time payments of interest are made. What that means is that if a Creditor Certificate has been issued but, unbeknown to borrower and lender, the Creditor Conditions are not satisfied, the borrower can nevertheless generally obtain the benefit of the QPP Exemption. Accordingly, HMRC has power to demand a Creditor Certificate be cancelled if it reasonably believes it to be materially inaccurate (a Cancelled Certificate) and similarly a lender must withdraw a Creditor Certificate if it becomes aware that the creditor confirmation ceases to apply (a Withdrawn Certificate). In both cases, a Creditor Certificate is invalid once the borrower has received notification from HMRC or the lender of any cancellation/withdrawal respectively, and a lender is obliged to inform a borrower that the Creditor Certificate is inaccurate as soon as practicable after it has become aware that the confirmation given has ceased to apply.

While the production of a Creditor Certificate places an administrative burden on investors, these requirements are much less onerous than under a full double tax treaty claim. The difference may, however, be minimal as compared to the filings required where a lender already has a DTTP number, as it is the borrower rather than the lender who is to complete DTTP filings.

The requirement for a borrower to have a Creditor Certificate in respect of every lender creates significant administrative difficulties for bonds held through clearing systems as, absent special arrangements, the borrower will not know the identity of the bondholders. We understand that Euroclear and Clearstream are discussing how to tackle this concern. Details are currently unclear but could involve a procedure similar to that for what ICSMA calls "unlisted Eurobonds" (see the International Capital Market Service Associations' Global Tax Procedures - Tax Relief Procedure for UK Unlisted Eurobonds). That procedure is pretty unwieldy, though, in our view.

QPP exemption in private placement documentation

The LMA released tax drafting in April 2016 to cover lenders using the QPP Exemption (New LMA Drafting). As discussed above, HMRC has confirmed that the QPP Exemption can apply to debts documented both as securities and as the sort of facility agreement more commonly seen in the syndicated loan markets. Accordingly, the New LMA Drafting comes in two formats: the Subscription Agreement and the Facility Agreement. The approach is the same in both documents. Below, we refer only to the Facility Agreement.

Generally, under such facility agreements, a lender must be qualifying lender in order to be entitled to the benefit of the gross-up. Qualifying Lenders have therefore previously included lenders who are entitled to the benefit of a UK domestic exemption from WHT, or lenders which are entitled to the benefit of a nil WHT rate under an applicable double tax treaty (subject to the completion of procedural formalities).

The key benefit of being a Qualifying Lender is that, in the event of a change of law which gives rise to UK WHT, the Qualifying Lender remains entitled to the benefit of the gross-up, whereas a non-Qualifying Lender would suffer the WHT without a gross-up.

The New LMA Drafting has introduced a new category of Qualifying Lender called the QPP Lender. The QPP Lender is one who has delivered a Creditor Certificate satisfying the Creditor Conditions outlined above and such certificate has not become a Withdrawn or Cancelled Certificate.

As set out at the start of this briefing, there are certain lenders that do not benefit from a zero WHT rate under a treaty (and thus cannot qualify as a Treaty Lender under LMA drafting) but which can benefit from the QPP Exemption. Those lenders will want to utilise the QPP procedure since it reduces the WHT to zero for them. However, there is a much larger pool of lenders that, subject to any contractual restrictions in the loan documentation, have the choice of whether to use the QPP Exemption or the withholding exemption available in the relevant Treaty. The New LMA Drafting offers those lenders both options. We note that the QPP Exemption effectively allows self-certification with consequent timing, cost and administrative benefits. Accordingly, we would expect that most such lenders would opt to use the QPP Exemption (rather than a treaty exemption) for those loans which contain the New LMA Drafting.

One practical point to note is that best practice for lenders relying on the QPP Exemption would be to provide a Creditor Certificate on signing, which is an extra document to go on the completion checklist.

The New LMA Drafting has not as at the date hereof been incorporated into all the LMA senior and leveraged loan documentation. However, the New LMA Drafting can be relatively easily transposed into new loan documentation, and we understand that this drafting will be included in future.

Given that a Creditor Certificate may be cancelled or the relief may not be available for reasons outside of a lender's control, lenders should be careful to ensure that there is an appropriate risk allocation under the documentation.

Transitional rules and existing loan documentation

Where all the applicable conditions are satisfied, the QPP Exemption is now available for all payments of interest, irrespective of when the loan was made or acquired. Existing facility agreements will not, however, provide for lenders benefiting from the QPP Exemption to be Qualifying Lenders entitled to gross-up on any change of law.

However, where all the applicable conditions are met, the documentation should not stop the borrower and a new lender from agreeing to use the QPP Exemption should they so choose. Indeed, once the markets become more used to using this exemption, that could become an increasingly common practice. The potential risk of taking that approach is that, depending on the precise drafting, that may well remove the change of law protection from someone that would have benefited from it had they applied for treaty relief. Accordingly, we think that for historical loans without the New LMA Drafting:

1. those lenders that can avail themselves of either treaty relief or QPP Exemption will choose to claim treaty relief; and
2. it will only be those lenders that would not obtain total exemptions under the relevant treaties that will choose to use the QPP Exemption.


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SPAIN

Spanish Court Denies Interest Deductions in Cross-Border Financing

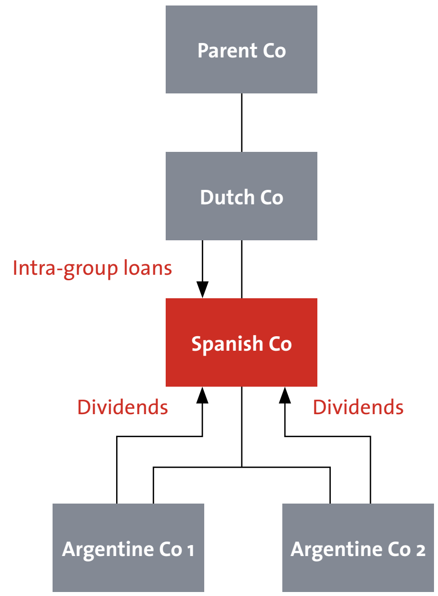
by **Eduardo Gracia and Lorena Viñas**

A landmark decision following the publication of the OECD's Final Report on Base Erosion and Profit Shifting in 2015 (the Final Report).

The Spanish Central Economic-Administrative Court (the Court) has held that the Spanish Tax Authority was right to deny interest deductions taken on an intra-group financing used to fund share purchases from a third party on the basis that the financing lacked commercial sense and would not have been entered into between independent third parties (Case 05110/2012/00/00). While we hope that the case will be appealed, the decision is, for now, binding. However, there is some doubt about whether any appeal will overturn the decision of the Court, which follows a decision made by the Spanish Supreme Court in 2014.

Background

A Spanish holdco in the form of an Entidad de Tenencia de Valores Extranjeros (Spanish Co) was part of an international corporate group (the Group). In October 2002, Spanish Co purchased 100 per cent of the share capital of two Argentine tax resident companies from a third party. Spanish Co's immediate Dutch parent company (Dutch Co) granted Spanish Co two loans totalling €1,103,505,252 to fund the purchases. The head of the Group was a Brazilian company (Parent Co) and Parent Co exclusively undertook all negotiations with the seller in respect of the share purchases. Spanish Co's only income was the receipt of tax-exempt dividends from its subsidiaries.



Key Points

- **The Spanish court has endorsed the aggressive position of the Spanish Tax Authority when examining cross-border related-party transactions.**
- **Spanish companies must be actively involved in transactions which impact them and must not have their decision-making powers usurped in order to protect the tax treatment of cross-border intra-group financings.**
- **Spanish businesses should expect closer scrutiny of cross-border related-party financings and increasing litigation in this area.**

Details of the Loans

The first loan (Loan A) was granted for a term of five years with a fixed interest rate of 4.76 per cent. The second loan (Loan B and together with Loan A the Loans) was granted for a term of six months with a fixed interest rate of 4.8 per cent. Interest payments under the terms of the Loans could not be capitalised and there was no flexibility for Spanish Co to extend the terms of the Loans.

Renegotiation of the Loans

On maturity of Loan A, the initial five-year term of Loan A was extended by one year, and then for a further year on expiration of that one-year extension. Loan A was therefore in place from 17 October 2002 to 16 October 2009. The fixed interest rate of 4.76 per cent was increased to 5.65 per cent for the first extension, and then reduced to 4.8 per cent for the second extension.

On maturity of Loan B, the initial six-month term of Loan B was extended for a further six-month period, and thereafter for periods of one year until 16 October 2009. On each extension of Loan B, the interest due on maturity was capitalised with the intention that payments under Loan B would then be made as and when Spanish Co had sufficient liquidity, i.e. when it had received sufficient dividend income from its subsidiaries. It is unknown whether the interest payments under the Loans equalled the dividends received.

Arguments of the parties

The Spanish Tax Authority denied Spanish Co the interest deductions on the basis that under both the Spanish rules on related-party transactions and Article 9 (Associated Enterprises) of the Spain–Netherlands Income and Capital Tax Treaty (1971), related-party transactions must be on an arm's length basis and no independent third party would have entered into an equivalent financing arrangement in an equivalent situation. Accordingly, the Spanish Tax Authority believed that interest deductions taken in Spanish Co should be added back and taxed accordingly.

Spanish Co argued that the interest deductions should not be denied on the basis that:

a. the Spanish domestic law on related-party transactions in force at the time of the transaction did not permit the re-characterisation of debt as equity; and
b. the interest deductions were not being used to reduce taxable profits in Spanish Co as Spanish Co's only income was tax-exempt dividend income. Furthermore, the interest payments made to Dutch Co were taxable in the Netherlands.

As Spanish Co had no taxable income we can only infer that it wanted to use the losses arising from deductible interest payments against another source of income elsewhere in the Group and that the Spanish Tax Authority was concerned about the accumulation of losses in Spanish Co.

Decision of the Court

The Court, without undertaking any economic or functional analysis of the financing or of the debt leverage assumed by the company, endorsed the approach of the Spanish Tax Authority in denying the interest deductions on the basis that no independent third parties would have entered into an equivalent arrangement. The Court gave the following reasons for reaching this conclusion:

a. Spanish Co's only involvement in the transaction was executing the share purchase documentation: Parent Co undertook all of the negotiations, including in respect of all key terms such as the consideration, and Spanish Co simply purchased the shares in accordance with the overall strategy of the Group. It was also a decision of the Group to fully finance the acquisition by way of an intra-group loan from Dutch Co to Spanish Co rather than an arrangement negotiated between Spanish Co and Dutch Co; and
b. as Spanish Co's only income was dividend income from subsidiaries, no independent third party would have been willing to enter into the financing arrangement and certainly would not have financed the acquisition solely by way of debt financing. Also, no third party would have continually extended the term of the financing or permitted repayments to be dependent upon liquidity in the form of dividend income. Furthermore, the interest deductions resulted in Spanish Co being loss-making.

The Court therefore held that the Loans should be re-characterised as equity and the interest deductions should be denied, without considering any transfer-pricing guidelines or the possibility of a partial disallowance of deductions, an alternative interest rate, the creditworthiness of Spanish Co, or undertaking any economic or functional analysis.

Interestingly, no penalties have been imposed by the Spanish Tax Authority in this instance.

Impact of the decision

One of the most significant aspects of the decision is the approach of the Court in simply examining the behaviour of the parties and determining whether a transaction lacks commercial sense, rather than undertaking any economic or functional analysis. The Spanish Supreme Court previously

took this approach in July 2014 and this principle is now expressly included in Spanish law. This, combined with the Final Report (in respect of Action Plans 8-10 (Aligning Transfer Pricing Outcomes with Value Creation)) "authorising the non-recognition of transactions which make no commercial sense", means that we should expect to see more transactions assessed on this basis by the Spanish Tax Authority. This is in contrast to the approach which the Spanish Tax Authority had been taking until recently in focusing on the valuation method when challenging related-party transactions.

Another significant aspect of the decision is the Court allowing the Spanish Tax Authority to use Article 9 (Associated Enterprises) of a double tax treaty to assess a transaction to tax and re-characterise a related-party transaction. The Spanish Tax Authority increasingly appears to be taking this approach and we therefore expect to see this line of scrutiny taken more frequently in the future.

Looking forward and action

The Final Report appears to be strongly influencing the decisions made by the Spanish Tax Authority and businesses may therefore wish to consider putting advanced pricing agreements in place, as uncertain times are ahead and we anticipate increasing litigation in this area.

Businesses should also re-examine the commercial rationale behind existing related-party transactions and ensure that they give due consideration to the commercial rationale behind future related-party transactions.

In the event of a dispute with the Spanish Tax Authority, businesses may want to consider using arbitration or the mutual agreement procedures contained in the EU Arbitration Convention and appropriate double tax treaties to resolve any dispute.

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AUSTRALIA

New 10% Withholding Tax

by Peter McCullough and Paul Glover

Certain disposals of Australian real estate will no longer be self-assessable by non-residents in historic move by the Australian Tax Office (ATO).

Disposal proceeds from the sale of certain Australian real property may attract a 10 per cent withholding tax (WHT) for contracts exchanged on or after 1 July 2016, and penalties for purchasers in the event that it is not withheld. While aimed at non-residents, the rules may also catch those residents without the correct paper work in place.

Why have these changes been brought in?

These measures are said to have been initiated on the back of the ATO's concerns that the self-assessment regime is, to a material extent, ineffectual. Our view is that this change has most likely come about because there have been a number of high-profile incidents where non-residents have sold arguably taxable Australian investments just ahead of unsuccessful ATO attempts to tax the sales proceeds. It is therefore the absence of any viable compliance mechanism, along with continued growth in the scale and range of foreign investments in Australian real property, that has prompted the Australian Government to make this significant change.

What will the WHT apply to?

The WHT will apply to disposal proceeds from the sale of both "direct" and "indirect" interests in Australian real property by Australian non-residents whether these are brought into account as income or as capital.

Direct interests in Australian real property consist of:

a Australian situs land, buildings, residential property, commercial property, or lease premiums paid for the grant of a lease;

b Australian mining, quarrying or prospecting rights;

c "company title" real property interests (e.g. apartment

Key Points

- **Failure to withhold new tax by purchasers of Australian real property interests from non-residents may expose the purchaser to penalties in historic move by the ATO.**
- **Sellers may want to seek an advance variation of the WHT from the ATO in the event the WHT will exceed the underlying tax payable. If not, sellers will need to apply for a refund in an income tax return.**
- **Secured lenders should be aware that this WHT creates a risk to their position of priority vis-à-vis creditors.**

buildings where ownership of the apartment is conveyed through the sale of shares in the company which owns the apartment); and

d options or rights to acquire any of the above.

Indirect Australian real property interests consist of:

a shares or units or other interests in entities the majority of the assets of which ultimately (tracing through all interposed entities) consist of any of the above types of Australian real property (N.B. this is not the same as "company title" real property interests); and

b options or rights to acquire any of the above.

Exclusions from WHT

In relation to the disposal of direct interests, only sales with a market value of AUD 2,000,000 or more attract WHT.

In relation to the sale of indirect interests, the following are excluded:

a "on market" transactions undertaken on Australian or approved foreign stock exchanges;

b transactions undertaken using private broker-operated crossing systems (e.g. dark pools);

c certain securities lending transactions; and

d sellers under external administration or bankruptcy.

Who will the WHT apply to?

While the intention of the legislation is for the WHT to only apply to non-residents, it may also apply to Australian residents without the correct paperwork in place at the time of settlement.

Practicalities

Different criteria need to be met depending on whether the property being disposed of is a direct or indirect real property interest.

In relation to sales of direct interests, a purchaser must levy WHT unless the seller provides a valid Commissioner clearance certificate (a CCC) on or before settlement. In the event that the purchaser does not receive a valid CCC on or before settlement, even if the purchaser is clearly an Australian resident and can prove this, the purchaser must

withhold. This process means that a purchaser will not need to undertake any timely due diligence on, or bear any risk in relation to, whether a seller is an Australian resident. It also means that the WHT on payments to non-Australian residents is automatic. Standard transaction documentation has been amended to incorporate this compliance requirement.

In relation to sales of indirect interests in Australian real property, there is a requirement, with one exception as discussed below, for a purchaser to levy WHT where the purchaser:

a knows or reasonably believes the seller is a foreign resident; or

b does not reasonably believe the seller is an Australian resident and the seller has an address outside Australia (according to any record in the purchaser's possession) or the payment is being made outside Australia.

The exception alluded to above is where, on or before settlement, the seller provides the purchaser with a valid declaration (probably in the form of a representation or warranty) that it is an Australian resident and/or the property is not an indirect Australian real property interest, provided the purchaser can show (having regard to any documents in his possession) that he has no grounds to believe that the declaration is false.

Process for obtaining CCC

The Government has indicated that the process for obtaining a CCC will not result in any onerous or time – consuming obligations. An Australian resident must fill out an online "Clearance certificate application for Australian residents" form and the ATO says that it will respond "within days" owing to a new automated system. The CCC will be valid for 12 months once issued.

ATO personnel will no doubt be grateful for the additional data on Australian resident transactions this process provides and it remains to be seen whether this will generate ATO audits or related information - gathering processes for Australian sellers.

Payment obligations

The purchaser must in effect remit an amount equal to 10 per cent of the purchase price to the ATO (but see below in relation to varying this amount) on or before the day of settlement of any transaction. Even where payments for purchases are made in instalments, an amount equal to 10 per cent of the total amount payable must be withheld and remitted upfront on the day of settlement.

The requirement to remit an amount on or prior to completion has introduced a material degree of additional complexity into the property settlement process – particularly in the early days of the new rules as parties familiarise themselves with new processes.

In the event that the seller's tax is less than the amount withheld, the seller can obtain a refund by filing an income tax return.

Protecting the seller's creditors

The ATO is given a largely unfettered right to vary the amount of tax that is required to be withheld, either up or down in amount. The only restriction on this is that the ATO "must have regard to the need to protect a creditor's right to recover a debt". This is the only protection offered to secured and unsecured creditors of the seller and it appears potentially insufficient. As a result, some creditors could, depending on the particulars of their situation, find themselves permanently out of pocket by reason of the withholding.

In theory, this power of variation should allow withholdings to be eliminated where it is clear that the seller will suffer a taxable loss from the sale prior to any withholding being levied. However, it remains to be seen whether variations will be available in practice. At present, it would be prudent to assume that they will not, as the drafters of the legislation have been at pains to leave the power of variation unfettered by considerations such as the lack of any underlying tax being payable. Moreover, the power of variation does not preclude the ATO from increasing the amount it may demand, which may be of concern to those persons who would otherwise be minded to apply for a variation.

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EU

EU state aid and tax rulings – the net widens

by Richard Palmer and James Seddon

Multi-National Enterprises (MNEs) that have received favourable tax rulings from EU Member State tax authorities (notably the tax authorities in Luxembourg and the Netherlands) continue to be within the scope of the European Commission's investigation into whether such rulings constitute unlawful State Aid with the risk that substantial amounts of tax 'saved' may have to be repaid.

EU Commission decisions in the cases of Fiat, Starbucks, the Belgian Excess Profit Rulings Exemption regime (BEPE) and, most recently, the Irish case of Apple, together with comments from the EU Competition Commissioner (Margrethe Vestager) suggest that more State Aid investigations may be forthcoming and we understand that the Commission is currently investigating up to 100 Unilateral Advance Pricing Agreements.

The Apple decision was announced only three days before we went to press and the full reasoned decision has not yet been released. We will therefore provide a full analysis in the next edition of this publication. It does seem from the announcement, however, that the technical basis for the decision may not be particularly robust – in particular the selectivity condition which is at the heart of the concept of State Aid has not obviously been addressed. The Irish government and Apple have both indicated their intention to appeal.

Key Points

- **Tax Rulings which comply with OECD transfer pricing guidelines may not necessarily prevent the existence of unlawful State Aid.**
- **MNEs with tax rulings granted by EU Member State tax authorities should review those tax rulings.**
- **MNEs (particularly US based MNEs) should consider whether the established existence of State Aid on facts similar to their own tax rulings requires disclosure in financial statements.**

Background

In October 2015, the European Commission issued final decisions confirming that the Governments of the Netherlands and Luxembourg conferred unlawful State Aid of at least EUR 20 million on both Starbucks' Dutch manufacturing company and Fiat's Luxembourg group finance company by granting tax rulings regarding the amount of profit to be shown and tax required to be paid in those jurisdictions.

Both Member States and Fiat (as one of the beneficiaries of the State Aid) have now made pleas for annulment of these decisions at the European Court of Justice.

Given that many MNEs will have tax rulings regarding the amount of profits and tax to be reported in the Netherlands and Luxembourg similar to those issued to Starbucks and Fiat, it is important to consider what these two State Aid decisions might mean for those MNEs.

The Fiat decision will be of particular interest for two reasons:

a the use of group treasury and finance companies amongst MNEs, as in Fiat, is perhaps more common than the use of toll or contract manufacturing companies seen in Starbucks; and
b Margrethe Vestager's comments to the European Parliaments TAXE 2 Committee in January suggest that Advance Pricing Agreements (APAs) issued by Member States to group financing companies may be subject to ongoing investigation.

The BEPE decision may also be relevant as it concerns what is effectively a profit allocation agreement which is similar to the unilateral APAs agreed with Tax Authorities to determine the level of profit to be reported by a group company in a jurisdiction.

What is State Aid?

The Four Criteria for State Aid

1 The existence of an advantage.
2 The advantage is selectively granted to certain undertakings.
3 The use of State Resources.
4 The creation of a distortion of trade between Member States.

State Aid can arise where the use of state resources results in an advantage being given to some over others in circumstances where the four criteria for State Aid are satisfied. Member States are prohibited from providing aid without the prior authorisation of the EU Commission; their intent being to safeguard fair competition within the EU.

While the EU Commission does not generally have competence over a Member State's system of direct taxation, it can intervene by opening investigations if a Member State's tax arrangements (usually in the form of tax rulings and tax incentives) breach State Aid rules. EU State Aid rules therefore apply to undertakings with business activities in Member States.

State Aid rules typically manifest themselves in one of two ways in respect of a Member State's tax arrangements:

a a tax regime or a specific tax measure provides a 'selective advantage' (e.g. a tax reduction or deferral) to a taxpayer or class of taxpayers; or
b a specific arrangement with a taxpayer (e.g. a ruling or APA) provides a selective advantage to that taxpayer.

Although four criteria need to be satisfied to find the existence of State Aid, in practice and under case law, the criteria listed as 1, 3 and 4 above are generally satisfied in relation to these tax arrangements.

Establishing a Selective Advantage

The courts generally adopt the following three-step analysis to decide whether a tax measure confers a selective advantage:

a identify the common or normal tax regime applicable in the relevant Member State (the 'reference system');
b determine whether the particular tax measure (e.g. the legislation, ruling or APA), constitutes a derogation from the reference system, insofar as it differentiates between economic operators who, in light of the objectives intrinsic to the system, are in a comparable legal and factual situation; and
c determine whether the measure is justified by the nature or general scheme of the reference system if the particular measures does differentiate.

The BEPE and Fiat decisions allow us to predict how this analysis will play out in a group finance context.

The BEPE and Fiat decisions

What is BEPE?

Pursuant to BEPE, Belgian resident companies that are part of a multi-national group were able to reduce their tax base in Belgium by deducting an amount of "excess profit" from their actual recorded profit. The "excess profit" is the actual amount recorded less the hypothetical average profit that a stand-alone Belgian company carrying out comparable activities could be expected to make in comparable circumstances. The rationale behind BEPE was to ensure that a Belgian group entity was not taxed on profits in excess of its arm's length profit, i.e. it was not taxed on any profits derived from benefitting from being within a multi-national group.

A company had to obtain an advance ruling to benefit from the BEPE.

The Fiat APA

Fiat Finance and Trade (FFT) obtained an APA from the Luxembourg authorities confirming the transfer pricing methodology to be applied to FFT's intra-group activities. The remuneration payable to FFT was determined by reference to the capital needed by FFT to perform its functions and to bear its risks, in relation to assets in use, and effectively allowed FFT to pre-determine its taxable profit in Luxembourg on a yearly basis on the basis of a level of capital which the Commission considered to be unjustifiably low. This, therefore, pre-determined the amount of corporate income tax payable in Luxembourg on the basis of that level of capital.

The reference system

In both the BEPE State Aid Scheme and the FIAT decision, the Commission was clear that a reference system must be a consistent set of rules applied on the basis of objective criteria to all undertakings within its scope as defined by its objective, i.e. the ordinary system of taxation of corporate profits under

the Belgian Corporate tax system and Luxembourg Corporate tax system respectively, the objective of which is to tax standalone or group companies on their profits.

BEPE was neither an inherent part of nor an application of this reference system; it was a derogation from that reference system since it was available only to companies that are part of a multinational group.

Similarly, in the Fiat decision the Commission rejected FFT and Luxembourg's assertions that the reference system should be restricted to companies subject to transfer pricing rules which had obtained APAs, as the reference system was the taxation of both standalone and group companies, and that they could not assess by reference to taxpayers who had obtained APAs as the APAs provided to the Commission were too inconsistent to constitute an appropriate reference system.

The Selective Advantage

The Commission considered that BEPE conferred a selective advantage on Belgian companies for three main reasons:

a it was only available to Belgian members of multinational groups;

b the rulings were effectively advance rulings in respect of future operations; and

c as BEPE only exempts profits which result from synergies and economies of scale related to being part of a multinational group, only those entities forming part of such a multinational group have an incentive to obtain a ruling under the BEPE.

In Fiat, the tax rulings constituted a derogation from the reference system leading to unequal treatment between Fiat and a stand-alone Luxembourg company. FFT's activities were similar to those of a bank, and therefore the taxable profits could be determined in a similar way to a bank. However, the parameters and calculations applied under the tax ruling to determine the arm's length remuneration were challenged by the Commission as artificial and inappropriate for the calculation of taxable profits reflecting market conditions. In particular a selective advantage arose due to remuneration being calculated by reference to an estimation of capital much lower than actual capital (due to a number of economically unjustifiable assumptions and downwards adjustments), and the rate of remuneration on the capital being lower than market rates.

Deviation from the arm's length principle

The essence of the Commission's decisions was that the methodology accepted by the Belgian and Luxembourg tax authorities, respectively, for determining the adjusted arm's length profit departs from a methodology that leads to a reliable approximation of a market-based outcome, and thus from the arm's length principle. The BEPE/ methodology agreed under the Luxembourg APA therefore lowered the taxpayer's tax liability under the corporate tax system as compared to undertakings in a comparable factual and legal situation.

The phrase 'reliable approximation of a market-based outcome' which is used throughout the decision seems to be the Commissions view of the arm's length principle and insofar as the Commission did not like the transfer pricing methodology used (in this case application of the TNMM) it decided that that amounted to a selective advantage and thus unlawful State Aid.

In the Fiat decision the Commission accepted that the remuneration based on the TNMM was an appropriate transfer pricing method to use, but held that the assumptions, parameters and calculations applied were not, because the capital to be rewarded is understated and the functions are not correctly stated. Similarly, the Commission did not object to the use of TNMM itself in the BEPE but rather that it was applied to both Belgian and non-Belgian parties at different stages of the process.

Many finance company rulings will undoubtedly have used TNMM, and will therefore need to consider, in light of the detailed comments by the Commission in the decisions as to the methodology and calculations used, whether that correct method has been used and whether that method has been applied to reflect a "reliable approximation of a 'market-based outcome'.

The Consequence of Finding Unlawful State Aid

As there was found to be no justification (for example to ensure the functioning and effectiveness of the tax system or to prevent double taxation) in BEPE, Fiat or Starbucks, the consequence of finding unlawful State Aid is for Member States to fully recover the amount of the State Aid for a period of up to 10 years.

It is a requirement of the Commissions State Aid decisions that they must set out either:

a exactly the State Aid granted; or

b a methodology for determining the amount of State Aid.

The BEPE decision sets out a methodology with the State Aid being the excess profit that was previously deducted from the BEPE calculation multiplied by the corporate tax rate in the relevant years together with compound interest.

However in the Fiat decision, the Commission states that, per previous decisions of the Court, it is not required to state the exact amount of aid to be recovered, and that Union law requires the recovery to "restore the position to the status quo ante and that repayment to be made in accordance with the rules of national law". The Commission therefore leaves it to the Luxembourg authorities to calculate the exact amount of aid to be repaid.

Companies resident in an EU jurisdiction (particularly Luxembourg, the Netherlands and Ireland) will need to consider the impact of the State Aid rulings whether or not they themselves are the subject of a specific State Aid investigation. The specific areas where the Commission appears keen to consider further investigations are:

a where there is 'stateless' income - typically with US based multinationals using hybrid vehicles such that the effect of the EU ruling is to leave passive income (such as IP income) taxed at very low rates in the EU jurisdiction and untaxed in the US until repatriated; and

b group finance rulings.

Companies should review their existing rulings to ensure that, from a transfer pricing perspective the rulings comply with the arm's length principles (as seen through the Commissions definition).

In June 2016 the EU Commission issued a working paper on State Aid and Tax Rulings, which addressed the differences in tax ruling practices of Member States and summarised the transfer pricing methods described in the OECD guidelines. This followed the Commission's Competition Directorate review of over 1,000 tax rulings issued by Member States. It appears that a considerable number of these tax rulings relate to transfer pricing based rulings that do reflect a reliable approximation of a market based outcome and cover intra-group transactions within Member States. Those are unlikely to lead to investigations. The paper, although not explicitly, gives an indication of where future State Aid investigations may go.

We consider that the focus going forward is very much likely to be on rulings that relate to:

a group financing and IP licensing activities within a group where a uniform ruling is applied regardless of the economic analysis; and

b unilateral tax rulings where only one party to the transaction requests a ruling endorsing transfer pricing approach that will typically TNMM based. Often the residual profit accrues to a company or entity that is untaxed or the residual income is stateless.

The overriding impression however is the confluence of State Aid as purely a transfer pricing issue so that if the basis of the ruling can be justified as a reliable approximation of a market based outcome (or only a limited deviation therefrom which is proportionate to the uncertainty in the transfer pricing method chosen), State Aid will not be present.

Many of the affected multinationals are US based, a point explicitly made in a letter from the US Department of the Treasury to the European Commission that pulled its punches in its disappointment at the ongoing actions of the Commission's State Aid enquiry arm. Those multinationals will need to consider whether they should be making disclosure in their financial statements for 'uncertain taxes', in accordance with Financial Accounting Standards Board Statement No.109. Where the tax benefits of EU rulings have been taken through financial statements, the recognition threshold requests that the tax position be more likely than not (i.e. greater than 50%) to be sustained based on its technical merit under applicable tax laws and based on a presumption that the tax position will be examined by the relevant taxing authority with full knowledge of all information and circumstances.

We expect to see a great many multinationals look to their advisors for opinions on the position.


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UK Residential Property

by Simon Swann, Tim Gummer and Martin Voelker

Ever-increasing complexity demands careful analysis of the factual background to transactions.

Since 2012, the taxation of residential property has become subject to a plethora of rules requiring detailed investigation not only of the property itself, but of who the purchaser is, what they intend to do with the property and how many properties they own.

Amid a political and popular backlash against rising property prices, seismic changes to the taxation of residential property have sought to target in particular property held otherwise than by individuals as a main residence. The higher rates of SDLT and capital gains tax, the annual tax on enveloped property and a proposed extension of inheritance tax combine to make structuring purchases of residential property highly complicated and fact-specific.

In order to understand quite how complex the position is in 2016, it is perhaps helpful to look back to 2012 and the position as it was before the changes of the last four years were introduced.

Key Points

- **Companies are subject to higher rates of SDLT and capital gains and the annual tax on enveloped dwellings.**
- **Buy-to-let landlords are subject to higher SDLT rates and restrictions on interest deductibility.**
- **Future changes may subject residential property to inheritance tax regardless of holding structure.**

Position on 1 January 2012

Upon acquisition, the following rates of SDLT applied to the purchase of a residential property:

Up to £125,000	0%
Over £125,000 up to £250,000	1%
Over £250,000 up to £500,000	3%
Over £500,000 up to £1,000,000	4%
Over £1,000,000	5%

The rates applied on a "slab" basis, meaning the whole consideration was taxed according to which band it fell within, at the prescribed percentage. The rates applied to all purchasers whether the purchaser was a corporation or an individual, regardless of what the purchaser intended to do with the property and how many properties the purchaser already owned.

A purchaser could expect to pay tax on any rental receipts from the property, at a rate dependent on whether they were within the charge to income tax or corporation tax (on 1 January 2012, up to 50 per cent for income tax payers, or 26 per cent for corporation tax payers). There was also capital gains tax to consider (assuming private residence relief was not available) upon disposal of the property. Rates

were dependent again on whether the seller was within the charge to capital gains tax or corporation tax, or perhaps not within charge at all if the seller was not a UK resident.

That, largely, was the end of the story, until March 2012. The Government then made a series of changes to the taxation of residential property, designed to reverse the use of so-called "envelopes", i.e. holding property in any way other than directly. The stated concern at the time was expressed to be future transfers of property without payment of SDLT.

From 2012

Against that background, from March 2012 the following changes were made:

a **15 per cent SDLT**

A 15 per cent charge to SDLT was introduced in Budget 2012, payable by purchasers who are "non-natural persons", acquiring "higher threshold interests".

While in 2012 a higher threshold interest essentially meant a residential property purchased for over £2,000,000, this has since been lowered to purchases of over £500,000.

There are exclusions where the property is acquired for:

1 property rental businesses, where the property is acquired for the purpose of letting to a third party at a rent on a commercial basis and the property is not occupied by any of the beneficial owner's connected persons;
2 development or redevelopment and resale in the course of a property development trade;
3 resale in the course of a property development trade;
4 making the property available to the public for at least 28 days a year;
5 provision to an employee of accommodation where the employee has less than a 5 per cent interest in the non-natural person and the provision of the accommodation is for the non-natural person's commercial purposes; and
6 a number of specific other reliefs for particular businesses such as farming.

b **7 per cent SDLT**

Although it has since been repealed, the Finance Act 2012 saw the introduction of a new 7 per cent rate of SDLT on properties valued at over £2,000,000, replacing the previous 5 per cent rate.

c **ATED**

Introduced by Finance Act 2013, the annual tax on enveloped dwellings (ATED) was a tax introduced and directed at those who continued to hold high-value residential property through non-natural persons, the idea being that the prospect of an annual charge for the ability to do so would encourage those who owned properties in envelopes to take them out of those envelopes. Originally applying to property valued at over £2,000,000, the ATED, like the 15 per cent SDLT charge, now applies to residential property valued at over £500,000. The amounts charged per annum have increased significantly since the introduction of ATED, no doubt because of the revenues which it has attracted for HM Treasury from those that are willing to pay it in order to preserve their indirect holding structures for other tax reasons. The fee payable per annum is set by reference to the property value, and is currently chargeable at the following rates:

Property Value	ATED
Over £500,000 up to £1,000,000	£3,500
Over £1,000,000 up to £2,000,000	£7,000
Over £2,000,000 up to £5,000,000	£23,350
Over £5,000,000 up to £10,000,000	£54,450
Over £10,000,000 up to £20,000,000	£109,050
Over £20,000,000	£218,200

Reliefs are available, broadly in line with the reliefs from 15 per cent SDLT, but must be claimed annually.

d **Taxes on capital gains – ATED-related CGT**

Coupled with ATED was the introduction of ATED-related CGT, where a charge to CGT is triggered when a property holder disposes of a property, currently for more than £500,000 (this was reduced from £1,000,000 on 6 April 2016 in line with 15 per cent SDLT and ATED). To the extent that ATED is chargeable on a residential property (i.e. no relief is available), the "ATED-related gain" that has accrued since April 2013 incurs a 28 per cent tax charge. These measures subjected non-UK non-natural persons to a CGT charge for the first time, and at the CGT rate applicable to individuals rather than at the lower corporation tax rates.

From December 2014

a **SDLT "slice" rates**

Changes to the SDLT rates were made again with effect from 4 December 2014. Replacing the previous "slab" system described above, the new "slice" system means that the amount of value falling within each band is taxed at the prescribed percentage. The overall result is that the effective rate of tax is increased for higher value properties and decreased for lower value properties:

0 to £125,000	0%
Over £125,000 up to £250,000	2%
Over £250,000 up to £925,000	5%
Over £925,000 up to £1,500,000	10%
Over £1,500,000	12%

b **Non-UK resident CGT**

In 2015, the focus of the Chancellor shifted away from residential property held in envelopes, to instead creating a "level platform" for UK and non-UK investors. Applying to all residential property regardless of value or holding structure in April 2015, the UK capital gains tax regime was extended to include disposals by non-UK residents. There is an opportunity for rebasing, which can be calculated either by reference to market value of the property on 6 April 2015 or a time apportionment exercise. The rates are the same as those applicable to individuals (up to 28 per cent) or companies (20 per cent), and relief is available for certain widely held corporate vehicles or funds. ATED-related CGT takes priority over the newer provisions, applying a penal rate of 28 per cent to high-value residential property held by a non-natural person (rather than the 20 per cent rate that would be charged under the new non-UK resident extended CGT principles).

2016 so far

In this year's budget, there have been yet more changes to taxation of the sector. This time, the focus has been on residential landlords and those acquiring second homes:

a **Higher rates (+3 per cent) of SDLT**

From April 2016, SDLT rates were increased further for purchasers acquiring buy-to-let properties or second homes, when they already own a residential property. This applies regardless of the property value to corporates and individuals alike. Broadly, where an individual purchases a property but already owns another residential property, he will pay an additional 3 per cent on top of the usual slice rates applicable to residential property, unless the property is purchased as a replacement for his main residence. For a company, the acquisition of any residential property will automatically attract these higher rates, unless the penal 15 per cent rate applies as described above (which is applied to the total consideration, not on a "slice" basis).

0 to £125,000	3%
Over £125,000 up to £250,000	5%
Over £250,000 up to £925,000	8%
Over £925,000 up to £1,500,000	13%
Over £1,500,000	15%

b **Restriction on interest deductibility**

The Government has announced that it will restrict relief on finance costs that individual landlords of residential property can claim to the amount of relief that would have been available to a basic rate taxpayer. The measure will be phased in from April 2017. This will apply regardless of property value. For example:

Current Position 2016–2017	
Property income	£15,000
Finance costs	(£10,000)
Other expenses	(£3,000)
Property profits	£2,000
Taxable income	£2,000
2,000 @ 45% =	£900
Tax =	£900
Position in 2020–2021	
Property income	£15,000
Finance costs	(£0)
Other expenses	(£3,000)
Property profits	£12,000
Taxable income	£12,000
12,000 @ 45%* =	£5,400
Tax reduction 10,000 x 20% =	(£2,000)
Tax =	£3,400

* assuming total taxable income for tax year exceeds £150,000.

c **Wear and tear allowance**

From April 2016, the wear and tear allowance previously available to residential landlords (which allowed landlords of furnished properties to claim an annual allowance of 10 per cent of the rent received, regardless of actual expense incurred) has been replaced by a relief that only allows the deduction of the actual costs to replace furnishings. The stated aim of the change was to give "greater consistency and fairness across the residential property letting sector and reduce the number of tax rules applying to the residential property sector".

Inheritance tax – proposed changes

The last four years have therefore seen a great deal of amendments to the taxation position for the residential property sector. Not only have there been changes year on year, but changes to those changes. However, arguably the most destabilising change for investors in prime residential property is yet to come. Although details have not yet been published, the Government announced in July 2015 that it intends to legislate to ensure that all UK residential property owned by non-UK resident individuals is to be subject to inheritance tax even if the property is held indirectly through an offshore structure. Details of those measures are expected in a consultation at some point

this year, to be then legislated for in the Finance Act 2017. If the Government proceeds with this seismic change, those offshore holding structures remaining in place which currently attract ATED may have little remaining benefit once HMRC is able to look through them for inheritance tax purposes.

Where are we now? How does the UK compare with other jurisdictions?

	Natural persons (i.e. individuals)	Non-natural persons
SDLT	0–15%	0–15%
ATED	n/a	Up to £218,200 p.a.
Tax on Income	✓	✓ For non-residents
CGT (UK)	✓	✓
CGT (non-UK)	✓	✓
IHT	✓	Not yet – proposed to be introduced in April 2017

It is beyond doubt that holding residential property in the UK as an investment has become less attractive from a tax perspective, particularly for non-UK residents, although the volatility in value of sterling following the Brexit referendum, may make acquisitions cheaper for foreign investors. The Government's stated direction of travel, particularly as regards inheritance tax, is only going to add to this. That said, the map above illustrates that London from a direct tax perspective continues to compare favourably with some of the major cities across Ashurst's global network.

An individual holding residential property as a buy-to-let investment in the jurisdictions listed below could expect to pay the rates of tax shown in the diagram above on profits made respectively on:

a rental receipts; and

b disposal.

1 These figures do not include any church tax payable.

2 Disposal proceeds may be realised tax-free if holding periods are observed.

3 Figures are approximate and dependent on rounding and other considerations, including phase-out of certain deductions.

4 Can be reduced to 35 per cent if the requisite holding period is met.

5 These rates include a 2 per cent medicare levy only applicable to residents. Rates will fall to 47 per cent after 30 June 2017.

6 Net income subject to ordinary progressive income tax (up to 45 per cent) plus exceptional contribution if high earner (3 per cent or 4 per cent) plus social contributions (15.5 per cent).

7 Full exemption may be available if certain holding periods observed.


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HMRC AND ASHURST JOINT BREAKFAST SEMINAR

The new corporate criminal offence of Failure to Prevent the Facilitation of Tax Evasion

Friday 16 September 2016, 8.00 AM – 10.00 AM

We are delighted to announce that Jennifer Haslett, Steve Mason and Christopher Draycott from the HMRC Centre for Offshore Evasion Strategy will be joining us to discuss the policy behind this new offence and give their perspective on the new governance processes that they expect companies to establish. Angela Pearson, Head of Ashurst's Global Anti-Bribery and Corruption Group will then highlight some of our practical experience of the implementation of Anti-Bribery measures (the framework upon which this new offence has been based).

This new corporate criminal offence is scheduled to be introduced to Parliament in September. Ashurst is pleased to invite you to this seminar to outline these new measures and their impact on your business.

Venue

Ashurst LLP, Broadgate Quarter, 9 Appold Street, London EC2A 2AP

If you would like to register for this event please email your interest to eleanor.thomas@ashurst.com