AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

BDO KNOWS: INTERNATIONAL TAXATION

A PUBLICATION FROM THE BDO UK/US TAX DESK

SUBJECT

THE UNITED KINGDOM GOVERNMENT ANNOUNCED ITS 2016 BUDGET ON MARCH 16, 2016, IN WHICH IT CONFIRMED THAT THE UNITED KINGDOM WILL BE PASSING LEGISLATION TO IMPLEMENT THE AGREED UPON ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (“OECD”) RECOMMENDATIONS FOR ADDRESSING BOTH HYBRID MISMATCHES AND INTEREST DEDUCTIBILITY.

SUMMARY

On March 16, 2016, Chancellor George Osborne announced the United Kingdom’s 2016 Budget. At the heart of the Chancellor’s speech was a business tax road map designed to take the economy to 2020 and beyond.

Two key measures included in the business tax road map stem from the outputs of the OECD/G20 Base Erosion and Profit Shifting Project (“the BEPS Project”). These are responses to the Final Report on Action Item 2: Neutralize the Effects of Hybrid Mismatch Arrangements, draft legislation for which has already been issued and the Final Report on Action Item 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, which was the subject of recent consultation.

The measures will be included in the United Kingdom’s Finance Bill 2016, and will apply with effect from January 1, 2017, for Action 2 and from April 1, 2017, for Action 4.

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DETAILS

Background

Action Item 2 of the BEPS Project is designed to ensure that multinational companies can no longer benefit from the use of hybrid instruments or hybrid entities. The use of such hybrids has enabled multinational companies to avoid tax on income that would otherwise be included in taxable profit.

Draft legislation implementing Action Item 2 was issued in December 2015. This takes into account the responses received following consultation, further discussions with stakeholders, and the Final Report issued by the OECD in October 2015. Mr. Osborne announced in the Budget that the draft legislation will be amended, prior to enactment, to widen the scope of the rules to eliminate the tax advantage arising from the use of permanent establishments.

Action Item 4 of the BEPS project seeks to eliminate base erosion by way of interest deduction and other financial payments. Following consultation, Mr. Osborne announced in the Budget that the United Kingdom will be implementing a fixed ratio rule limiting corporation tax deductions interest.

BEPS Action Item 2

The UK draft legislation follows the OECD's recommendations closely and applies to seven types of hybrid arrangements.

Deduction/non-inclusion mismatches

Four of the hybrid arrangements targeted fall within what is termed "deduction/non- inclusion" mismatches. These are arrangements that include: hybrid financial instruments; hybrid transfers (e.g. repo/stock lending type arrangements); payments made by a hybrid entity payer; and payments made to a hybrid entity.

In each case, where a payment or quasi-payment is made by a UK entity, the United Kingdom will deny a tax deduction to the extent that the income is not included in the taxable income of the recipient. Where the payee is subject to UK tax and the payer jurisdiction has not implemented rules under BEPS Action Item 2, the United Kingdom will include the payment (that would otherwise not be taxed) in UK taxable profits. In that case, where the hybrid recipient is a UK Limited Liability Partnership ("UK LLP"), the United Kingdom will include the payment in UK taxable income as if the UK LLP were a UK resident company.

There are exclusions from the application of these rules, i.e., where there is a "permitted reason." Permitted reasons are where the recipient is: a person not liable to tax on any profits; a person being subject to tax that is not charged on foreign source income; a person not being liable to tax on the ground of sovereign immunity; or certain offshore funds and authorized investment funds.

It should also be noted that, generally, deemed deductions that arise only for tax purposes, e.g., notional interest deductions, should not be caught.

Double deductions

Two of the hybrid arrangements targeted involve double deductions. These are where there is a double deduction in a hybrid entity or in a dual resident company. Broadly, the rules apply to deny UK deductions where there is a deduction elsewhere for the same expense, and that deduction is not offset against income that is included in the taxable profits of both relevant territories.

Imported mismatches

This rule applies where there is a series of arrangements whereby a UK payer makes a non-hybrid payment to another entity and that entity, in turn, makes a payment to a third entity. If the payment to the third entity falls within any of the six hybrid arrangements above, the new UK rules will deny the non-hybrid deduction in the UK payer.

In each case above, the new rules apply to either related parties (which has a 25- percent threshold for capital, voting or value) or control group companies (which has a 50-percent threshold for capital, voting or value, or applies where companies are consolidated for accounting purposes), and to structured arrangements.

Extension to permanent establishments

Mr. Osborne announced in the Budget that the draft legislation will be amended, prior to enactment, to widen the scope of the rules to eliminate the tax advantage arising from the use of permanent establishments.

The example included in the business tax roadmap is of a UK company paying interest to a finance branch of a company in a third country. The interest income is not taxed in the head office county because of a participation exemption for the branch, and the income is not taxed in the branch because there is no taxable PE in the branch territory due to limited activity there. This might be, for example, a Luxembourg company with an Irish non-trading branch.

BEPS Action Item 4

The United Kingdom will be introducing a restriction on the tax deductibility of corporate interest consistent with the recommendations in BEPS Action Item 4. Specifically, the United Kingdom will introduce a fixed ratio rule from April 1, 2017, that will limit corporation tax deductions for net interest expense to 30 percent of earnings before interest, tax, depreciation, and amortization (“EBITDA”). This applies to third party and connected party net interest expense.

It is recognized that some groups have high borrowing levels for sound commercial reasons. A group ratio rule based on the net interest to EBITDA ratio for the worldwide group will also, therefore, be implemented.

To ensure that the new rules are targeted at larger businesses, there will be a de-minimis group threshold of GBP2m of net UK interest expense.

Draft legislation implementing the changes has not yet been issued, as consultation is ongoing in respect of the detailed design of the rules. The current worldwide debt cap rules will be repealed, but rules with similar effect will be integrated into the new rules.

BDO INSIGHTS

The United Kingdom Government has fully embraced the agreed rules set out in the OECD's BEPS Action Item 2 and these new rules will enter into effect for payments made on or after January 1, 2017.

There will be no grandfathering of existing arrangements and there is no commercial purpose override as there is with the UK's existing anti-arbitrage rules. Although the new legislation will largely impact debt financing arrangements that make use of hybrid instruments or hybrid entities, other payments, e.g., royalties, rentals, or other expenses are within scope. The new rules will therefore present multinational companies with a significant challenge in maintaining a low effective tax rate if the use of hybrid techniques has been one of the principal means of lowering global taxes.

Groups with existing hybrid mismatch arrangements should consider now how they might restructure to be ready to enter into new arrangements before the commencement date of January 1, 2017.

Groups should also consider the potential impact of the implementation of BEPS Action Item 4 on interest expense deductibility in the United Kingdom.

For further information or a discussion about the impact of the proposed new rules on your particular circumstances, please contact Ingrid Gardner or your BDO tax advisor.