

## Tax disputes: six key themes at a glance



Key issues for enquiries: transfer pricing, permanent establishment, diverted profits tax, withholding tax, interest deductibility.



Tax authorities are seeking increasingly significant amounts of information, with taxpayers needing to consider options to narrow the scope of requests and control the flow of information.



Advance Pricing Agreements can often turn into audits for past periods, including discovery assessments. There is greater complexity in agreeing APAs today.



Tax enquiries are becoming more aggressive. HMRC is using diverted profits tax as a lever to shift the bargaining power.



Tax authorities are under pressure, politically and more broadly, to increase tax revenues from multinationals as a way to 'fill the tax gap'. Are targets for tax authority officers a possible next step?



Tax authorities are growing in sophistication. They have greater resources, bigger and more specialised teams, and better tactics for cooperation, both internally and with their foreign counterparts.

**REMEMBER:** Facts don't win cases; perceptions do.

## Fortress Europe: A parting of the ways and implications for tax

### Customs and VAT - free movement of goods

The European Single Market means that goods and services can move freely within the 28 Member States of the EU, without any customs controls. Absent a future trading relationship, the UK will be forced to trade with Europe under the World Trade Organisation (WTO) model, in the same way that the EU trades with countries like China and the US.

At present, the UK benefits from more than 50 free trade agreements by virtue of being in the EU. If access to these is lost following Brexit, this could result in: import VAT being chargeable; customs duties; export/import declarations; greater administration costs and potential delays at the border. In fact, the UK Chamber of Shipping has warned of 'catastrophe' looming at ports.

The UK expects to enter some form of free trade agreement with the EU. However, free trade agreements do not literally allow 'free trade', but rather preferential rates for the movement of goods, under certain conditions.

Post-Brexit there could be issues with the distribution of products where the UK is used as a distribution hub. Customs or bonded warehouses may become more popular to keep goods in duty suspension before shipping them onwards into Europe. Questions also remain as to whether a UK entity can continue to act as an importer of record after Brexit, whether additional customs duties may be imposed on the distribution of goods and whether the customs value of products might be higher post-Brexit.

### Corporate tax

The UK has indicated that post-Brexit, it does not want to be bound by the European Court of Justice. If the UK is no longer subject to state aid rules, or if the UK loses the benefit of any of the key EU tax directives such as the Parent-Subsidiary Directive, the Interest and Royalties Directive or the Merger Directive, this would be significant.

Such changes could lead to increased withholding tax costs, and will force the UK to rely on its network of double tax agreements. There is particular concern about the 5% dividend withholding tax that would apply to dividends from German to UK companies and HMRC has indicated that one of its top priorities will be the urgent renegotiation of this treaty.

### State aid

Article 107 of the Treaty on the Functioning of the EU, which contains the general prohibition on State Aid, is a cornerstone of the Single Market. The state aid rules have increasingly been used by the Commission in recent years to crack down on certain harmful tax practices, which cannot be challenged on other grounds.

There have been three broad categories of state aid challenge relating to tax authority rulings: (i) that confirm transfer pricing arrangements -- where such arrangements may not be on arm's length terms; (ii) on profit allocation -- where the distribution of profits among group entities has not been done on arm's length terms; (iii) that facilitate hybrid mismatches -- for example, income that is not taxed in any jurisdiction.

The most important factor to consider in determining whether state aid has been conferred is whether a "selective advantage" has been granted.

In addition to rulings, tax settlements, tax amnesties, fixed base tax regimes and incentives could all be deemed to be state aid.

The Commission seems to want to develop a new arm's length principle for state aid, which will likely target, in particular, those Member States already on the Commission's radar for having issued tax rulings that are potentially open to state aid challenge.

### EU tax policy

The EU's approach to tax matters can broadly be divided into three phases:

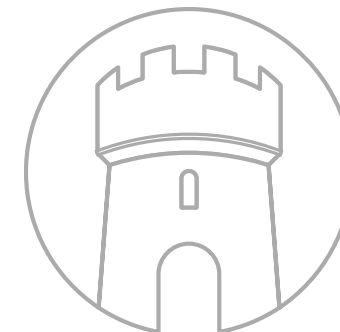
**Phase 1:** historically, securing free movement and minimising the risks of double taxation.

**Phase 2:** more recently, ensuring a fairer tax system and further minimising the risk of double non-taxation, for example, through the changes to the Parent-Subsidiary Directive and the Anti-Tax Avoidance Directives.

**Phase 3:** moving forward, potentially encouraging greater harmonisation, which may see a reduction in tax competition across the EU, for example, through the CC(C)TB proposals for a common consolidated corporate tax base. However, these are struggling to make progress, with a number of Member State not in favour.

### Conclusion

There is significant uncertainty as to the potential shape of UK and EU tax policy. It remains to be seen whether the walls will go up around Europe to create a fortress of harmonised anti-avoidance rules, state aid challenges and high regulation, and what the UK's position is likely to be. Some have suggested that the UK could become a "Singapore of the West" -- that is, a low tax and low regulation haven on the edge of the fortress, but the recently agreed EU Brexit Guidelines show that the EU would try to prevent such a move in determining its future trading relationship with the UK.



## International arbitration and double taxation: all over the MAP

### Cross-border tax disputes are on the rise...

2500

Approximate number of outstanding Mutual Agreement Procedure (MAP) cases at the end of the year. (OECD, 2015)

It can be difficult to resolve tax disputes amicably. Access to MAP is problematic; in some countries domestic law thresholds are imposed.

BEPS Action 14 (Making dispute resolution procedures more effective) lays down minimum standards for countries to adopt to make MAP more effective and accessible.

OECD MAP peer review process is already under way and is driving certain countries, such as China, to ensure that targets are met.

### Arbitration: emerging from the shadows?

Arbitration is a potentially effective way to resolve tax disputes, but it is rarely used.

In that respect, change could be on the way. An optional treaty article on mandatory binding arbitration in the BEPS Action 15 Multilateral Instrument could make a difference.

27

Number of 27 countries likely to opt into mandatory binding arbitration.

Which arbitration method will be favoured:

BASEBALL  
(last best offer)

REASONED  
OPINION

Baseball forces parties to put forward a reasonable position, and has been used successfully in the US and Canada, but it is less familiar outside the US. There is some resistance from developing countries, owing to a lack of resources and experience, which affects their bargaining position.



The European Commission is also getting in on the act with its own, quite radical proposals on tax dispute resolution. These include a fast-track process for arbitration by an advisory commission. It could become much more common in treaty-based tax disputes, and no longer restricted to transfer pricing.

## Recharacterisation of transactions: at a glance

### The view from the OECD:



A tax administration should not disregard the actual transaction or substitute other transactions for it unless exceptional circumstances apply.



(Chapter 1, Section D, paragraph 1.121 of the Transfer Pricing Guidelines)

### The Baker McKenzie translation:

Taxpayers should **NOT RELY** on their view that a transaction is not exceptional. This is a very subjective area.

### Five points to consider:



The post-BEPS changes to the Transfer Pricing Guidelines have prompted a reaction in some quarters that recharacterisation is now easier for tax authorities to implement. However, this view has been dismissed by the OECD, which has confirmed it is not trying to lower the bar on recharacterisation.



Tax authorities aggressively pursuing this approach are ignoring those aspects of the OECD Transfer Pricing Guidelines they consider unfavourable. The best defence when confronted with this line of tax authority argument is a thorough and accurate delineation of the transactions under question. Business arguments for reorganisations are often forgotten, so taxpayers should document the commercial rationale for structuring and changes whenever they occur.



Discussing recharacterisation with tax authorities can be dangerous. Instead, taxpayers should discuss the terms of the transaction while avoiding a debate on its structure. Alternative positions will be constructed on the tax authority's terms and, if accepted, will likely lead to higher tax charges than would result from settling a dispute over the correct range of pricing to use for a given transaction.



The UK is currently riding the BEPS wave with Diverted Profits Tax used by HMRC as the main weapon to apply recharacterisation.



Questions remain as to whether we will see a transfer pricing case reach court in the UK anytime soon. Sensible case law in this area would be welcome, but the risks are high. We anticipate litigation only in very clear-cut cases, where one side has what they perceive to be an obvious advantage.

## US Policy and Tax Reform: what's in the pipeline on Capitol Hill?

In April 2017, the Trump administration released its 'Tax Reform for Economic Growth and American Jobs'. The one-page plan was labelled 'the biggest individual and business tax cut in American history', yet it was scant on detail. Below, we share the White House's tax memo on business reform, annotated by Baker McKenzie.



### Tax Reform for Economic Growth and American Jobs

#### Goals for Tax Reform

- Grow the economy and create millions of jobs
- Simplify our burdensome tax code
- Provide tax relief to American families—especially middle-income families
- Lower the business tax rate from one of the highest in the world to one of the lowest

#### Business Reform

- 15% business tax rate
- One-time tax on trillions of dollars held overseas
- Territorial tax system to level the playing field for American companies
- Eliminate tax breaks for special interests

#### Process

- Throughout the month of May, the Trump administration has held listening sessions with stakeholders to receive their input and will continue working with the House and Senate to develop the details of a plan that provides tax relief, creates jobs, and makes America more competitive — and can pass both chambers.

- Simplifying 'burdensome' regulation is likely targeting the Section 385 regulations on related party debt. It's doubtful that Treasury will be able to meet its deadlines for making the required reports, so prospects for repeal are uncertain.

- The 15% rate is unlikely to be revenue neutral. It's likely this rate is an opening salvo and the final rate is likely to be higher.

- In the short term, it seems that only the business rate tax and the one-off repatriation tax have any chance of being introduced.

- There is no mention of a Border-Adjusted Tax (BAT), advocated by Speaker of the House Paul Ryan. The BAT was seen as too controversial for fear that it would drive up prices for consumers in the US, but ruling out the BAT has shut down another avenue for revenue.

- The Senate will need to produce its own version of any tax legislation, which is likely to differ from the Paul Ryan blueprint, and this may take several years to prepare.

- It's not clear whether President Trump supports a single rate for overseas earnings, or a bifurcated rate between cash and non-cash assets. Congress may adopt a single rate for simplicity and revenue purposes, and that rate may be in the range of 8-14%.

- At present, multinationals allow overseas cash to build up and wait for a repatriation holiday, a situation that has become untenable. A one-off tax on overseas dollars would likely be used to fund a move to a territorial tax system, rather than on infrastructure spending or other priorities for the Trump administration.

## Finance: where's my relief?

Historically, the basic principle of capital structure theory was that debt is cheaper than equity, in part because interest expense was deductible for tax purposes whilst dividends are not. Recent developments around BEPS Action 4 will challenge the historical principles. Here, we look at its UK implementation.

### Issues to consider...



Tax deduction on the cost of external borrowings cannot be taken for granted; even one times global interest shield could be challenging.



Geographically diverse groups are more likely to be affected by the new limitations, especially groups with operations in developing countries.



General uncertainty on tax relief available for interest expense especially during periods of volatile EBITDA.



Potential risk of double taxation (e.g. denial of interest deduction, foreign tax, UK CFC charges and withholding tax).



Significant impact for highly leveraged investments (e.g. real estate investment and development projects) with impact on company valuations and cost of capital.



Potentially less flexibility in managing the group's effective tax rate. If debt financing does not deliver a tax shield, other techniques will need to be considered.

### Actions for UK business...

#### Review existing financing arrangements...

- Analyse historical data to consider potential impacts (internal and external) of the proposed rules. Model scenarios to identify structural inefficiencies and reduce volatility.

#### Reduce structural inefficiencies...

- Push down debt to local territories such that EBITDA and global interest shield is matched.
- Move profitable activities to the debt issuer countries to align the location of taxable profits with the location of economic activity.
- Change the debt issuer: issue new debt from territories where there are profitable activities.
- Re-size or re-price the existing debt.

#### Align EBITDA volatility with interest capacity...

- Discuss with auditors the possibility of recognising deferred tax assets in relation to disallowed interest, thereby ensuring any denial is only a cash and not a book tax issue.

#### Educate board members and finance team on proposed tax law changes...

- Tax changes should be factored into investment decisions and in establishing systems and processes to give early warning of any EBITDA volatility.
- Days of double dip structures are gone. Focus on achieving one times global interest shield on external debt.