Budget comment

The impact on MNCs

Something to offend everyone?

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This article highlights the main Budget announcements which impact multinational businesses. Obviously, space considerations prevent both detailed analysis of the measures outlined, as well as being able to cover everything that may be relevant. So the focus is on measures which have not been previously announced, or where there have been substantial changes or developments since being announced. I have also avoided, where possible, cross over with the excellent contributions elsewhere in this edition.

Should we just call it 'the economy'?

In the context of Action 1 of the BEPS project, the Task Force on the Digital Economy considered the tax challenges raised by the digital economy. The 2015 Action 1 BEPS final report and the 2018 Action 1 BEPS interim report note that the digital economy is characterised by reliance on intangibles, the massive use of data and adoption of multi-sided business models. The reports also highlight ways in which digitalisation has exacerbated BEPS issues and note measures proposed under the other BEPS Actions that would have a significant impact in this regard. The most relevant measures included amendments to the permanent establishment definition in article 5 of the OECD Model Tax Convention (Action 7), revisions to the OECD Transfer Pricing Guidelines related to article 9 of the OECD Model Tax Convention (Actions 8–10) and guidance based on best practices for jurisdictions intending to limit BEPS through CFC rules (Action 3). The implication being that certain measures could be introduced to address the challenges of BEPS by digital businesses whilst the OECD consider sustainable, long term options for taxing the digital economy. The UK also took unilateral domestic action, with the introduction of the diverted profits tax (DPT) in 2015 and the extension of withholding taxes on royalties in the last two years (more on these later in this article).

However, a key message from both Action 1 reports is that the digital economy is becoming the economy itself. The 2015 report concluded that it is extremely difficult to ring-fence the digital economy for tax purposes. What is also clear from both reports is that a robust understanding of how digitalisation is changing the way businesses operate and how they create value is fundamental to understanding the challenges of taxing the digital economy.

Given all of the above, the chancellor appears to have either bowed to the pressure of public debate on this issue, or maybe even used it as political cover, and decided to introduce a digital services tax from April 2020. So far, we know that the government will introduce a new 2% tax on the revenues of certain digital businesses which derive value from their UK users. The tax is intended to apply to revenues generated from the provision of the following business activities: search engines, social media platforms and online marketplaces which are linked to the participation of UK users, subject to a UK revenue threshold of £25m per annum. Furthermore, only groups that generate global revenues from such business activities in excess of £500m per annum will be subject to the tax, and the legislation will include a safe harbour provision that exempts loss-makers and reduces the effective rate of tax on businesses with very low profit margins. The government will consult on the detailed design of the rules and legislate in the Finance Bill 2019–20. Importantly, there is no detail as yet on profit allocation for the purposes of this proposal.

The UK chancellor had recently raised the prospect of an 'Amazon tax' for online retailers amid fears that high street retailers are being put out of business. At first glance, this tax is targeted at large multinationals, and is therefore not going to assist with levelling that particular playing field. I did also wonder if there are any grounds for arguing that the way in which the tax is narrowly targeted means that it could constitute illegal state aid. Brexit (in whatever form it takes) will presumably have happened by the time the tax is introduced, but the UK has committed to maintaining a state aid regime (and such a regime may be required under the terms of any agreement concluded with the EU). The government has also announced that the UK will continue to participate in international discussions, even if they were somewhat vague about the difficulties of being aligned to international developments in this area. However, given that it was also announced that the tax would be reviewed in 2025, this suggests that HM Treasury may be concerned that an EU or OECD solution is further away than these organisations believe.

However, the primary concern with this proposal is likely to be the reaction of the current US government, which has made no secret of its scepticism for the digital economy project. You could argue that this is entirely self-serving on their part, but a number of the 'case studies' used in this area are US headquartered multinationals, and some of these same entities are already facing increased taxation as a result of domestic measures in EU jurisdictions or EU state aid proceedings. The Trump administration has repeatedly warned of the dangers of inhibiting growth of such businesses, and is clearly willing and able to enact unilateral measures to deal with what it perceives as deliberate targeting of US businesses. It seems an odd time to push this tax through, when a post Brexit trade deal with the US will be crucial to the UK's economic future, but perhaps the chancellor believes that such US multinationals erode the UK tax base unfairly and do not pay tax where the 'value' is created.

Speaking of which...

Certain other areas of the tax code which can complement the taxation of digital businesses have, surprisingly enough, also been the subject of announced changes (although such changes are not limited to this type of business).

With effect from I January 2019, the government will alter the domestic definition of a permanent establishment by amending CTA 1020 s 1143, denying the exemption

from a PE in the UK if the UK activities are part of a fragmented business operation. This effectively means that non-resident businesses should not be able to artificially fragment their operations to avoid creating a permanent establishment (PE) in the UK by relying on the specific activity exemptions. This is one of the changes that a country can make to its double tax treaties by ratifying the multilateral instrument (MLI), but this change also has to be included in the UK's domestic tax law, notwithstanding that the UK has deposited its instrument of ratification.

The government has also announced technical amendments to the diverted profits tax (DPT) which are aimed at preventing profits being taxed under both DPT and corporation tax, and extending the review period during which HMRC and the relevant entity may collaborate to determine the extent of any DPT charge (including allowing the diverted profits in question to be brought into corporation tax rather than DPT). There will also be a change to prevent a company amending its corporation tax return after the review period had ended and the time limit for a DPT charge has expired, which had previously presented a planning opportunity for certain tax payers. The policy paper published alongside the Budget states that all of these measures will have effect on and after 29 October 2018, but confusingly the overview on this new measure provides that they will apply from royal assent, 'but will be deemed to have always had effect where they are wholly relieving'. I guess we will find out what that really means in due course.

It cannot be a coincidence that there is also a further broadening of the scope of income tax as it relates to the taxation of intangible property. Tax professionals are no doubt familiar with recent changes to royalty withholding tax, but the government is taking this one step further by legislating to require non-resident countries to pay 20% tax on gross receipts from intangible property to the extent that those receipts are referable to the provision of goods or services in the UK. There will be consultation on the various exemptions that will be needed from this measure, but it has been confirmed that this tax will not apply to companies resident in a jurisdiction which has a tax treaty with the UK containing non-discrimination provisions. There will, however, be a domestic joint and several liability provision which will allow for collection of this tax from connected parties where the non-resident entity does not pay. The measure will have effect from 6 April 2019, which does not give HMRC much time to get this important piece of legislation correctly drafted.

The government has also announced two further reforms to the corporation tax treatment of intangible fixed assets, following the joint HMRC and HM Treasury consultation published in February 2018 and draft legislation will be published in the Finance Bill outlining that:

- a specific relief for the cost of goodwill will be reinstated with effect from April 2019 for the acquisition of businesses with eligible intellectual property; and
- the intangible degrouping charge rules will more closely align with the substantial shareholding exemption (SSE). The reform will have effect from 7 November 2018 and should mean that a charge should not arise where the degrouping event qualifies for relief under the SSE.

Real estate funds

The long running saga of the changes to taxation of property continues, and there are a number of announcements in the Budget that people should review. Not least because the changes come at a time when uncertainty is not welcome as the UK seeks to attract more international capital. However, I have focused on the specific issues raised by the extension of the non-resident capital gains tax rules to commercial property owners and how this impacts offshore fund structures. The Finance Bill will contain the draft legislation as it relates to such entities when it is published on 7 November 2018.

The government has sought to deal with concerns that there is the potential for taxation at both the fund and investor level. HMRC has engaged extensively with interested parties (for which it should be commended) and the legislation will seek to address various technical issues. At this stage, we know the following:

- an offshore fund within the scope of the rules will be defined by reference to collective investment schemes as defined in FSMA 2000, or an AIF or REIT under existing tax legislation (or foreign equivalents thereof);
- any indirect disposal made by investors in such funds may be subject to tax i.e. the 25% threshold outlined in the main body of the draft legislation will not apply. However, it will be possible to make one of two elections where the relevant fund is 'UK property-rich';
- a fund that is tax transparent for income purposes, such as 'Baker' trusts, would also be able to elect for tax transparency for gains, and therefore the investors rather than the fund would be taxable on a disposal of underlying property; and
- any eligible fund can make an exempt election, such that it would be exempt from tax on a disposal of UK property by the fund, and instead defer the charge until the investors receive value from the fund through a sale of units or distribution.

There are a number of unknowns, including whether there will be additional reporting and administration requirements, or whether funds will need to meet some form of diverse ownership test in order to be eligible to make the above elections. However, the government has also announced that the capital gains exemption for disposals by UK property rich REITs will be extended to include share sales of UK property rich entities by REITs.

What is clear is that the property industry holds vast amounts of investment assets and capital through such structures, and with the new rules due to come into force in April 2019, this legislation has been much anticipated.

And the rest

The following is a quick summary of certain other measures that MNCs should monitor:

- further tinkering with the loss relief rules, with a proposal to introduce an equivalent (to last year's new rules) restriction on the proportion of carried forward capital losses that can be used against capital gains, with a single £5m deductions allowance that can be set against income and/or capital losses;
- a number of changes to the capital allowances rules;
- further technical changes to the GAAR, set to take effect in 2020;
- technical amendments to VAT grouping rules;
- a consultation on hybrid capital instruments; and
- stamp tax changes with respect to connected party transfers at an undervalue.

I must confess that this Budget caught me slightly by surprise, as I had not expected quite so many new announcements. So, in conclusion, there should be something in this Budget to offend everyone! ■