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Briefing

International review for February

Speed read

The UK's final regulations implementing DAC 6 should give businesses and intermediaries further clarity on the operation of the EU tax disclosure rules. Four new territories, including Cayman Islands, have been added to the EU's blacklist whilst 16 countries have made it off the grey list. The OECD has made further progress on developing a consensus solution to the tax challenges arising from the digitalisation of the economy, and it has also issued its long-awaited transfer pricing guidance on financial transactions. India announced its 2020 Budget. Finally, China has implemented tax rules to help contain the coronavirus spread.

Tim Sarson
KPMG
Tim Sarson is a tax partner at KPMG in the UK. He has worked in the international tax and transfer pricing field since 1998, in both practice and industry. Email: tim.sarson@kpmg.co.uk; tel: 020 7694 4831.

UK's final DAC 6 regulations

Whilst last month's update (*Tax Journal*, 31 January 2020) mentioned that the regulations to transpose DAC 6 into UK law have now been presented before Parliament (SI 2020/25), it is worth looking into how the latest updates have shaped the regulations, especially as the first reporting deadline is fast approaching.

The territorial scope of the rules has been narrowed by the introduction of new definitions for 'UK intermediaries' and 'UK relevant taxpayers'. The aim is to ensure that the rules do not apply to intermediaries without a connection to the UK, which is in line with the intention of DAC 6.

Whilst HMRC acknowledges that some duplicate reporting of arrangements is inevitable, the final regulations ensure that the same intermediary does not have an obligation to report in multiple jurisdictions.

The final regulations also ensure that a disclosure that would breach legal professional privilege does not have to be made. As DAC 6 intends, the obligation to report would now be passed onto another intermediary or relevant taxpayer to whom the privilege does not apply.

The final regulations do not directly address the fact that the UK should soon cease to be a member state of the EU. That said, the accompanying consultation response states that, under the terms of the withdrawal agreement, the UK is legally obliged to implement DAC 6 prior to the date that the UK leaves and during the subsequent transition period. However, given the uncertainty surrounding the UK's future relationship with the EU, the jury is still out on whether this may change.

Four additional countries hit the EU 'blacklist'

On 18 February, EU ministers agreed to add four jurisdictions – the Cayman Islands, Palau, Panama and Seychelles – to the EU list of non-cooperative jurisdictions known as the 'blacklist'. The blacklist is part of the EU's effort to clamp down on tax avoidance and harmful tax practices and is designed to encourage included jurisdictions to make changes to their tax regimes by adopting internationally recognised measures that should reduce potential harm to the EU tax base. Under the EU listing process, jurisdictions are assessed against three main criteria: tax transparency, fair taxation and real economic activity. Those that fall short on any of these criteria are asked for a commitment to address the deficiencies within a set deadline. These four jurisdictions were considered to have failed to comply with the required standards within the deadline. The new additions join American Samoa, Fiji, Guam, Oman, Samoa, Trinidad and Tobago, the US Virgin Islands and Vanuatu on the list, taking the current total to twelve.

The listing of the Cayman Islands is an interesting development given the size of the territory's financial services sector and investment flows. The Cayman Islands government recently passed the Private Funds Law and the Mutual Funds (Amendment) Law, which it thought address the EU's concerns for CIVs. These laws came into force on 7 February, after the 4 February meeting of the EU Code of Conduct Group to advise EU finance ministers and prior to the ECOFIN decision. It is therefore possible that the Cayman Islands will be removed from the EU blacklist at the next opportunity (in October 2020). The Cayman Islands government has said that it has already made that request.

As part of the update, 16 jurisdictions, including Armenia, Montenegro, Bermuda and the Bahamas, were found to have fulfilled their commitments within the 2019 deadline and, as result, were removed from the EU 'grey list'. The 13 jurisdictions remaining on the grey list will be closely monitored by the Code of Conduct Group and will be reviewed ahead of the next update.

OECD developments

The digital economy

The OECD has made further on developing a consensus solution to the tax challenges arising from the digitalisation of the economy, although this is perhaps not surprising given the ambitious deadline of 2020.

In the final week of January, the OECD Inclusive Framework decided to move ahead with a two-pillar negotiation following the public consultations on both pillars at the end of 2019. Specifically, in order to progress with pillar 1, the framework has agreed on a document which contains an outline of the architecture of a 'unified approach'. The main elements of the approach have not changed but there are new considerations included in the paper that are worthy of mention such as a revised scope which considers two main categories of businesses, threshold revisions and clarifications on 'amounts A, B & C'.

A progress report has been provided on pillar 2, which notes that good technical progress has been made on many aspects. Key design issues for the income inclusion rule and the undertaxed payment rule are being examined, with the working group focusing on the use of the parent company's financial accounts as a starting point to determine income. There are ongoing constructive discussions around rule coordination, simplification, thresholds and international obligations and the working group is also considering the types of blending and questions on carve-outs.

The OECD has already set out a number of steps for 2020 in an attempt to keep to the schedule, although it feels as if the likelihood of meeting the deadline hinges on the role played by the US during negotiations given that many US tech giants would fall within scope.

Transfer pricing

On 11 February, the OECD released its long-awaited guidance on financial transactions. This represents the first time the OECD has produced final definitive guidance on financial

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transactions, so this is a huge change in the transfer pricing landscape. The paper now becomes Chapter X of the OECD Guidelines.

On economic substance, in line with the wider OECD guidelines published in 2017, the paper puts much more emphasis on a two-sided approach and the economic substance to a transaction. Historically, support has been driven by what the borrower *could* and *would* do (i.e. the need for finance and the ability to service it), however now consideration also needs to be given to the lender. This consideration is two-fold: (i) would the lender be willing to lend (are there more attractive investments available?); and (ii) is there sufficient economic substance in the lender (i.e. does it have the functions to control the risks associated with the loan as well as the funds to bear those risks?). Where there are insufficient functions, the lender may only be entitled to a risk-free return on its capital. This could have significant consequences for groups where the lending entity and the treasury function are in different jurisdictions, so a robust functional analysis is key.

When discussing credit rating, the paper highlights the significance of both the group's business strategy and industry factors on the arm's length quantum of debt and the rate; with particular emphasis of these qualitative factors when arriving at an appropriate credit rating of the borrower. In addition, care needs to be taken that quantitative data (e.g. revenue, cost of sales) used for credit ratings is arm's length stressing the importance to groups that they need to also consider their wider transfer pricing policies.

For guarantees, the economic benefit from the guarantee can result in either better terms of borrowing or a greater amount of debt being offered to the borrower as a result of the guarantee. Where the guarantee is acting to support a greater amount of debt, the paper suggests the transaction should be recharacterised as a portion of the loan being from lender to guarantor (followed by an equity contribution from the guarantor to the borrower). As with credit ratings, it is important to quantify and remove the implicit support when pricing the guarantee. While the paper considers most of the previously used methods to price guarantees as potentially acceptable, it stresses the importance of determining real economic benefit from the guarantee.

The paper says that cash pools should be assessed holistically, with the main focus being on calculating and allocating the benefits of the cash pool to participants. It also states that generally, a cash pool leader performs 'no more than a co-ordination or agency function' and so the remuneration should be 'similarly limited'. However, if the leader's role involves assuming more risks (e.g. liquidity, credit, or currency risks), the transactions may be better characterised as intra-group loans.

Predictably, captives are subject to multiple challenges in the paper, including whether: there is sufficient diversification of risk to characterise the transaction as insurance; there is an economic capital benefit to both the group and its members; that benefit arises from group synergies (in which case the insured members should share this through lower premiums); and the captive or another group member exercises control of risk. Where the captive satisfies all the tests, a method is proposed to establish arm's length pricing as a benchmarked return over claims and expenses, plus an arm's length investment return.

The guidance should prompt businesses to undertake a thorough review of intra-group financial transactions and assess whether functions and control of risks are in the same place as financial returns, as well as to review and update transfer pricing policies, documentation and legal agreements to ensure that they are aligned with the economic substance.

China: tax and the coronavirus epidemic

In response to the coronavirus outbreak, China's tax and finance authorities issued two guidance documents named 'Announcement 6' and 'Circular 19' which set out preferential measures to support businesses and citizens during the fight against the outbreak.

Announcement 6 clarifies that between 1 January and 31 March 2020, imported supplies donated by domestic and foreign donors to be used for prevention and control of the epidemic, can be exempted from import duties, import VAT and import consumption tax. Circular 19 extends the February 2020 statutory tax filing deadline to 24 February 2020. As the virus continues to spread, it will be interesting to see whether and how other territories respond from a tax perspective.

India: Union Budget for 2020/21 presented

On 1 February, the Indian finance minister presented the 2020/21 Union Budget before parliament. The Budget proposes a vast number of amendments, many of which will be relevant for non-resident entities.

Importantly, it has proposed that the dividend distribution tax levied on dividends declared, distributed or paid by domestic companies to shareholders is to be abolished and subsequently replaced with a classical system of taxation of dividend income in the hands of recipient shareholders. Also, domestic companies declaring dividends to non-residents will be obliged to withhold tax at a rate of 20% or as per any lower beneficial tax treaty rate. In the case of resident shareholders, the tax is required to be withheld at the rate of 10%. Additionally, a dividend received by a domestic company from another domestic company is to be set-off while calculating its total income, to the extent of dividends further distributed by it up to one month prior to the due date of filing of return.

Other proposals include:

- Relaxing the tax return filing requirements for non-resident companies.
- The existing significant economic provision (SEP) rules constituting taxable business connection for non-residents have been omitted from 2021/22, with a view to inserting new provisions with effect from 1 April 2022.
- Widening the ambit of the SEP rules to include income from: advertisements which target Indian customers; the sale of data collected from persons residing in India or having internet protocol address located in India; and the sale of goods and services using such data collected from persons residing in India or having internet protocol address located in India.
- Bringing the determination of profits attributable to a permanent establishment in India of a non-resident within the scope of the advance pricing agreement rules and the safe harbour regime. Any interest paid to an Indian branch of a non-resident bank would be excluded from the application of the thin capitalisation rules under the transfer pricing provisions.

The recently elected second Modi ministry aim to boost income and enhance purchasing power through the budget set out. However, as with all budgets, it remains to be seen as to whether the policies will be as effective as planned. ■

- International review for January (Tim Sarson, 31.1.20)
- The UK DAC 6 regulations: the good, the bad and the unknown (Brin Rajathurai, 5.2.20)
- Digital taxation: a bluffer's guide (Eloise Walker, 3.2.20)