MILESTONE TAX NEWS

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The Milestone Outlook

Welcome to the first MTN of 2012, as usual slightly later than anticipated but better than nowt! What will the next 12 months hold for us? Well, despite what we read and hear most mornings, we're already sensing a change in our clients' outlook which on the whole seems to be very positive, especially as regards M&A activity in relation to distressed assets (no real surprise there then!). With any luck we can all start to enjoy life a little more in 2012.

From a tax perspective we've had a wager on what each of us thinks will happen this year. Ewa has taken the bull by the horns and thinks that human rights and tax are going to be hot topics; I'm sticking my neck on the line and think that the 50% tax rate will be gone by this time next year. Andy who, being a Kiwi, is fully familiar with the workings of a GAAR, reckons Graham Aaronson's proposals will be enacted sending the scheme-pirates running for the hills and Conor believes that the "remittance for investment purposes" exemption will be a major boost for non-doms.

In this MTN we look at the new UK CFC rules and how they work in conjunction with offshore finance functions. This is a major and somewhat surprising policy development and any UK business that operates internationally should be considering how they can benefit from these provisions. Ewa has written an article on the interaction of the UK's anti-avoidance rules relating to offshore trusts and EU law in the context of a potential Group Litigation Order we've been made aware of. If all that wasn't enough we review the landmark Indian Vodafone case that will no doubt come as a major relief to inbound investors after a number of investor-unfriendly decisions and rulings.

Happy Reading!

The Milestone Tax Team

DEAL OF THE WEEK

Transfer Pricing Benchmark Review

We were recently engaged to provide a sign-off on a UK transfer pricing benchmarking study. The advisors who had prepared the study had used the Transactional Net Margin Method (**TNMM**) to analyse the intercompany transactions within the client group. The key question was whether TNMM was the correct methodology in the circumstances. Without going into all the factual details, we concluded it was.

Choosing an appropriate methodology is critical as transfer pricing litigation is on the increase. In the UK the ***DSG Retail Ltd v HMRC*** case was ground-breaking in that it was the first TP case to go before the UK Courts. By contrast North America has led the way in transfer pricing litigation. In Canada, for example, the *GlaxoSmithKline* case that has been running for years has finally moved onto the Supreme Court and the *McKesson* ruling is imminent.

In the above mentioned cases the comparators used by the respective companies to establish the arm's length criteria were challenged by the Revenue authorities. Choosing one method over another will often produce significantly different results and the taxpayer will unsurprisingly attempt to use the methodology that provides the best result for their purposes.

ALSO IN THIS ISSUE...

The UK transfer pricing rules were initially enacted by Schedule 28AA ICTA 1988 and then by s164 TIOPA 2010 (the latter for accounting periods ending on or after 1 April 2010 and, for the purposes of income tax, the year 2010 and 2011). Specific reference is made in the above provisions to all 'The OECD Transfer Pricing Guidelines' **(The Guidelines)** to 1 May 1998.

The original OECD Transfer Pricing Guidelines imputed a hierarchy of methods such that it was inappropriate to use a transactional profit method (e.g. TNMM) without first establishing if a 'traditional method' could be applied. The reason for this, according to the Guidelines, is that methods such as TNMM do not necessarily take into consideration critical differences between associated enterprises and those independent enterprises that are used as comparators.

On 22 July 2010 the OECD published revised Guidelines that remove the old "hierarchy of rights" and focus instead on the selection of a method that is the most appropriate in each individual case. This is a significant and welcome change, but the problem, as always, lies in the detail.

The UK transfer pricing rules were updated again by Finance Act 2011 to reflect the revised Guidelines. The new UK rules apply to accounting periods on or after 1 April 2011 for corporation tax purposes and to the tax year 2011/12 and subsequent years for income tax purposes. Because the revised Guidelines do not have any direct effect on UK law for accounting periods ending on April 2010, s164 TIOPA is applicable in connection with the 1998 Guidelines.

It will be interesting to see how HMRC will deal with businesses that select TNMM as an appropriate method in the 2010 accounting year, knowing that the revised Guidelines were published but had not been adopted into UK law.

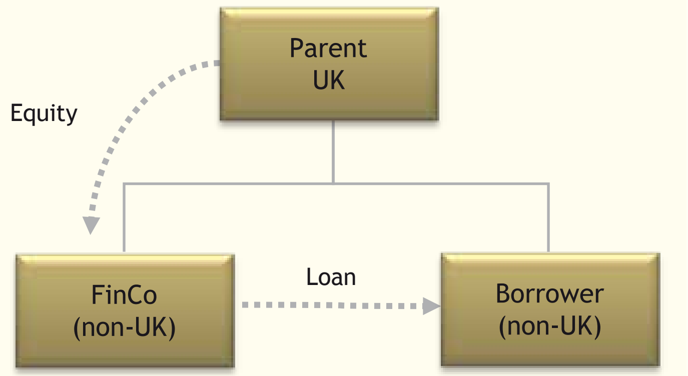
For more information on the UK's Transfer Pricing rules please click **here** to download the summary we have prepared.

UK

UK CFC Rules and Finance Companies

On 6 December 2011, HMRC published a set of draft Controlled Foreign Company (**CFC**) rules to be included in Finance Bill 2012. An updated version of the rules was published on 31 January and they have not, thankfully, been watered down to any great degree. These rules include a surprisingly generous group Finance Company Partial Exemption (**FCPE**) that potentially allows UK groups to "offshore" their finance function, such that only 25% of the offshore financing profits on loans to non-UK resident connected companies will be attributed back to the UK.

This would potentially allow a UK Parent to equity-fund (though not wholly) a non-UK finance company (**FinCo**) that could then use these funds to make intra-group loans to non-UK group companies.



Under the proposed rules, a quarter of the resulting financing profit of FinCo would be attributed to the UK Parent so that the financing profit is subject to an effective UK tax rate of only 6.25% (reducing to 5.75% from 2014). We recommend that such structures should be considered by all UK groups with overseas interests as part of their effective tax rate management strategy.

In implementing such a structure one would need to manage the withholding tax exposure on loans provided by FinCo (particularly since the proposed rules provide that only 25% of any withholding tax leakage will be available as a tax credit for UK Parent). So, in choosing the jurisdiction of FinCo one will need to consider:

i) withholding tax rates levied by the borrower jurisdiction; and
ii) withholding tax rates under applicable tax treaties.

Because of the potential withholding tax exposure, it may therefore be preferable for FinCo to be resident in a treaty jurisdiction. Equally important, however, is to ensure that FinCo is located in a jurisdiction with low/no tax on financing profits.

An even more interesting structure (and one that we think trumps the FinCo structure) is the establishment of an offshore finance branch of the UK Parent. The FCPE rules potentially extend to foreign branches of UK Parent and, in theory, allow the finance function to be undertaken in a non-treaty, no tax jurisdiction (e.g. Channel Islands or Isle of Man). The benefit of the finance branch structure is that the UK's double tax treaty network would be relied upon in respect of the interest withholding tax rather than a third country as would be the case with the FinCo structure.

As with all international tax planning, the success of such a structure requires that the residency and permanent establishment risks be effectively managed. Essentially, this means that the finance function must be genuinely carried on through FinCo (or the branch) in the FinCo jurisdiction and that management and control of FinCo is conducted in the offshore jurisdiction.

We have recently published a more detailed article on the CFC reforms and you can download a copy by clicking **here**.

If you are interested in receiving more information on how Milestone can assist in implementing a FinCo structure please contact **miles@milestonetax.com** or **conor@milestonetax.com**

INDIA

Vodafone Judgment

On 20 January 2012 the Supreme Court of India delivered its long awaited judgment in the controversial Vodafone case. The Supreme Court's decision came as a result of Vodafone's appeal against the decision of the Bombay High Court (see MTN 27).

A quick reminder of the facts:

- Netherlands resident Vodafone International Holdings (**Vodafone**) paid USD 11.2 billion for the acquisition of 100% shares in CGP (Holdings) Limited (**CGP**), a resident in Cayman Islands. The latter was acquired from Hutchison Telecommunications International Ltd (**HTI**);
- CGP controlled 67% of an Indian entity, Huitson Essar Ltd (**HE**), now Vodafone India Ltd, that owned various Indian licenses; and
- as a result of the acquisition Vodafone assumed control over CGP (and therefore HE).

The Indian tax authorities claimed that the acquisition in question was in fact an indirect transfer of an Indian *situs* capital asset and that tax of USD 2.5 billion should have been withheld by Vodafone. The position of the tax authorities was upheld by the Bombay High Court.

One of the key issues being litigated was whether or not the Indian tax authorities had jurisdiction to proceed against Vodafone as the tax authorities were seeking to apply the Indian domestic provisions extra-territorially.

The Supreme Court set aside the Bombay High Court ruling ending one of the most reported (and controversial) tax disputes of recent times. According to the Supreme Court:

- there was no territorial jurisdiction for the Indian tax authorities to claim tax where the transaction was made between two non-resident parties: the contract was executed outside India and consideration was passed outside India. Therefore the transaction had no nexus with the underlying assets in India;
- Vodafone was not liable to capital gains tax on the transaction and it had no obligation to withhold tax;
- the transaction was a genuine commercial transaction taking into consideration the best interests of the investors and was not a fraudulent or dubious arrangement designed to avoid capital gains tax;
- the fact that Hutchison's Cayman Islands business was in place for several years before the deal suggested that the structure was not created with the purpose of sidestepping taxes; and
- taxing Vodafone "would amount to imposing capital punishment for capital investment."

The latter point is clearly correct and reflects our views (expressed in MTN 27). The Indian tax authority's attempt to impose Indian taxes extra-territorially could have had a major economic impact on inbound investment. Not only is the decision legally correct, but it is also a common sense one. However, care should be taken, as the facts and circumstances of each case will have to be carefully examined from the perspective of tax avoidance. Notwithstanding that, the decision can be viewed as a useful guide in Indian tax planning.

UK ANTI-AVOIDANCE AND EU LAW

Sections 720 ITA 2007 and 13 TCGA 1992 (and perhaps s86?)

In March 2010 two major UK anti-avoidance provisions (s720 ITA and s13 TCGA) were attacked by the European Commission on the basis that the provisions were considered to be in breach of certain European fundamental freedoms (see MTN 27). Very little has been heard since and we thought it would be useful if we explained the process that is underway and how other UK anti-avoidance measures might be brought into the fold.

By way of background, the European fundamental freedoms are enshrined in the Treaty on the Functioning of the European Union (**TFEU** or **Treaty**), formerly the Treaty of Rome. As European Citizens we have a number of freedoms, the most important of which, in the context of tax, are as follows:

- freedom of movement of goods (Art 28 TFEU)
- freedom of movement for workers (Art 45 TFEU)
- freedom of establishment (Art 49 TFEU)
- freedom to provide services (Art 56 TFEU)
- freedom of movement of capital (Art 63 TFEU).

Put simply, these fundamental freedoms ensure that national (i.e. domestic) tax laws do not discriminate between residents and non-residents. For example, in relation to a critical personal anti-avoidance provision (s720) UK tax law does not attribute the income of a UK company to a UK shareholder but it does attribute the income of a non-UK company to that UK shareholder. To the extent that a domestic provision is discriminatory and unjustifiable the European Commission, empowered by Art 258 TFEU, can deliver a reasoned opinion on the matter after giving the State in question an opportunity to submit its observations (i.e. the opportunity to defend its position). If the State does not comply with the opinion within the period laid down by the Commission the matter can be brought before the ECJ.

The Commission sent its formal notice to the UK on 22 March 2010. The reply of the UK, which was sent on the 15 July 2010, was considered by the commission to be unsatisfactory and the next step appears to be that the UK will be referred to the ECJ.

In addition to s720 and s13, the UK has specific provisions relating to capital gains realized by offshore trusts (i.e. gains of an offshore trust can be attributed on an arising basis to the settlor – see s86 TCGA 1992). Could s86 also be considered contrary to the fundamental freedom of establishment?

Potentially yes. However, we consider there are two main problems connected with this proposition. Firstly, the creation of a trust is unlikely to be regarded as an "establishment" from the perspective of Art 49 TFEU. However, if trusts are recognised by the Treaty, trusts should be able to rely on the freedom of movement of capital. It should be noted that the ECJ has not, to our knowledge, previously considered the treatment of trusts from the perspective of the fundamental freedoms in any of its judgments (though given that trust law is primarily a product of common rather than civil law, this is perhaps not surprising).

Assuming trusts are covered by the Treaty then s86 can only be in breach of EU law to the extent that it is discriminatory (i.e. if domestic legislation applies such that gains of a resident settlor-interested trust are attributed to the settlor). Section 77 TCGA 1992 was the provision that attributed gains of a domestic settlor interested trust to the settlor. This provision was, however, repealed on 6 April 2008 such that gains of a domestic settlor interested trust are taxed at the level of the trustees and not attributed to the settlor. As such, despite the fact that UK tax is paid, albeit at the trust level, it might be possible to argue that s86 is indeed discriminatory.

In our opinion it is only a matter of time until further UK anti-avoidance provisions come under the EU spotlight. The UK might not like its domestic provisions being watered down (thereby allowing tax planning that until now might not have been so easily accessible); however, such changes are, we think, inevitable and perhaps the reason why HMRC/HM Treasury are not dancing to the EU's tune.

For more information please contact **ewa@milestonetax.com**

MILESTONE

Milestone. Registered office: 45 Clarges Street, London W1J 7EP
Registration number: OC 342622
VAT Reg no. 944 478291

LONDON

Milestone International Tax Partners LLP
45 Clarges Street
London
W1J 7EP

Phone: +44 (0)20 7016 5480
Fax: +44 (0)20 7016 5481
Email: info@milestonetax.com
www.milestonetax.com

DUBLIN

Milestone International Tax Partners Ltd
4th Floor
Ulysses House
Foley Street
Dublin 1

Phone: +353 (0) 1 876 4550
Fax: +353 (0) 1 888 1171
Email: info@milestonetax.com
www.milestonetax.com

UK Alliance Partner

Transfer Pricing Associates