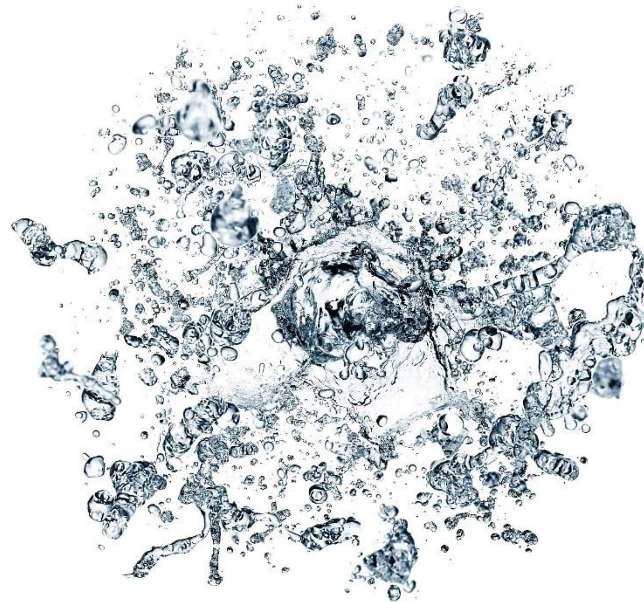
Deloitte.

International Tax for Asset Managers update
Fall 2017



A global focus on the investment management industry

In this issue (Please note: the content in this issue was written by Deloitte UK):

United Kingdom: Brexit: Tax considerations for UK asset managers operating in the EU 01

United Kingdom: Diverted Profits Tax: An extra-territorial tax on profits diverted from the UK 03

United Kingdom: UK tax governance framework for US managers 06

United Kingdom: Anti-avoidance: Impact of the new disguised investment management fee rules on US managers with UK operations 08

United Kingdom: Transfer pricing for investment management businesses 10

United Kingdom: Legislation introduced to counteract hybrid mismatches is potentially very wide reaching in application 12

Contacts 15

United Kingdom:

Brexit: Tax considerations for UK asset managers operating in the EU

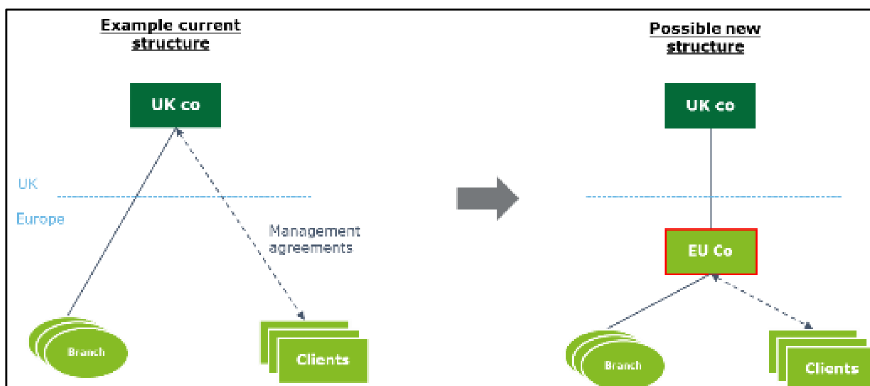
The UK's departure from the EU could have a significant impact on how UK-based asset managers operate within Europe.

EU "passporting" rules currently give UK regulated companies access to the EU single market. UK-based asset managers may currently rely on these passporting rights to:

- Distribute products in the EU, for example through branches; and
- Manage assets for EU-based clients.

The impact of Brexit on these arrangements is currently unclear. But it is likely that some UK managers will need to make structural changes to continue operating across the EU. Such changes are likely to include undertaking more activity through companies established in the EU ("EUco").

The transfer of activity from the UK to EUco presents a number of significant tax considerations.



Where to establish EUco

Legal and regulatory considerations, together with the location of existing operations, are likely to be the key drivers of where EUco is located. But tax will have an impact which should be assessed too.

An obvious question is whether the activity which is transferred to EUco will be subject or more or less tax than in the UK. This is likely to depend on a number of factors, including how much activity is transferred to EUco, what profit the transferred activity generates, and how local tax rates and rules are applied to those profits.

If EUco is based in a jurisdiction with a lower tax rate than the UK's, like the Republic of Ireland, the new structure could generate tax benefits. However, anti-avoidance rules would need to be looked at, like the UK's controlled foreign companies and diverted profits tax rules.

Currently, an EU directive can remove withholding tax from dividends paid by an EU subsidiary to its EU parent. So a dividend received by a UK company from an EU subsidiary should currently be free from withholding tax. Once the UK leaves the EU, this withholding tax exemption may not apply, and UK companies may need to rely on tax treaties for relief. However, not all tax treaties provide a full exemption from dividend withholding, so repatriating profits from EUco could lead to withholding tax leakage on dividends.

As with any structure which involves the cross-border provisions of services, VAT should be looked at carefully. This is particularly so where EUco will be operating through branches. At the moment, charges between overseas branches and their head office are normally VAT-free. However, many EU jurisdictions are changing their rules to impose VAT on certain transactions between a head office and its branches. Whether (and how) these changes are adopted in EUco's jurisdiction could have a significant impact on the VAT treatment of any new structure.

Different jurisdictions also have different rules on how VAT exemptions are applied, when entities can form a "group" whose members do not need to charge VAT to one another, and the way in which input VAT can be recovered. They also have different rates of VAT. All of these will have an impact on VAT costs in a post-Brexit structure involving EUco.

Transferring operations to EUco

Having decided where to establish EUco, the next key consideration relates to the transfer of activity to it. The transfer of assets from one company to another is normally a market value disposal for tax purposes, and possibly a supply for VAT purposes too. Where the assets are valuable, there is the risk of creating significant tax liabilities.

Reliefs can mitigate these liabilities in many situations. For example, reorganization reliefs may allow the branch assets to transfer tax neutrally in the EU branch's territory. But conditions will need to be met, and it may also be necessary, or advisable, to obtain a ruling on their application.

Interestingly, in some EU jurisdictions, the reliefs permitting tax neutral transfers could potentially be clawed back if the transferor ceases to be an EU company within a defined period. This means that, when the UK leaves the EU, taxable gains could potentially crystallize on previously-transferred branch assets.

UK companies are generally subject to UK tax on assets held by overseas branches. The transfer of branch assets may therefore be a disposal for UK tax purposes too. Again, reliefs and exemptions may allow the assets to transfer tax neutrally, although there are complexities which need to be considered.

The transfer of management agreements to EUco can also be problematic. A cross-border transfer of a UK asset, on the face of things, is a market value disposal by the UK management company, and potentially a VATable supply too. It is important for managers to identify the agreements which may need to transfer, and the value which could be ascribed to them, and the "exit charges" they may face.

Operating EUco

Once EUco has been established and activity has been transferred to it, the focus will be on operating it as efficiently as possible. Ideally, these operational considerations should have been assessed as part of the jurisdiction selection analysis.

As noted previously, key issues are likely to include VAT leakage arising on cross-border charges, exposure to different rates of corporate tax, and the risk of withholding tax on profit repatriation.

Where staff need to be relocated or will be travelling between the UK and EUco's jurisdiction, managers will need to have policies and frameworks in place to meet business requirements and also comply with the applicable tax, social security, and immigration rules.

Managers will also need to consider strategies for rewarding and incentivizing EUco's staff. They will need to understand the local regulatory requirements on remuneration, how to structure local pension arrangements, as well as legal issues pertinent to participation in global incentive plans, the transfer of employee data, as well as employment rights.

The more practical day-to-day consequences of operating EUco should not be overlooked either, for example tax registrations, filings and other compliance obligations.

United Kingdom:

Diverted profit tax: An extra-territorial tax on profits diverted from the UK

Introduction

Diverted Profits Tax (DPT) is an entirely new UK tax introduced to counter the diversion of profits by multinationals from the UK to low-tax jurisdictions, using artificial arrangements that either lack economic substance or avoid the creation of a UK permanent establishment (PE).

The rules were introduced with effect from 1 April 2015, in response to perceived aggressive tax planning techniques adopted by certain multinationals. DPT was introduced before the publication of the final reports of the G20/OECD Base Erosion and Profit Shifting (BEPS) project, and the UK's position is that DPT is entirely complementary to and consistent with BEPS.

DPT exists alongside transfer pricing and applies similar principles. However, even a robust transfer pricing position is no guarantee of falling outside of the rules, where arrangements lack economic substance.

At 25%, the rate of DPT is higher than UK corporation tax (currently 19% and scheduled to fall to 17% by 2020), with the aim of encouraging affected multinationals to adjust the UK aspects of their structures to fall within the corporation tax regime.

DPT is designed to fall outside of UK double tax treaties and, as such, the usual treaty provisions relating to PEs, taxation of business profits and avoidance of double taxation do not impact the application of the rules.

Impact for US asset managers

While the DPT rules are not specifically aimed at asset management, they have potentially wide application. For a US asset manager, DPT is particularly relevant where a group member in a low-tax jurisdiction provides services to a UK subsidiary or branch.

DPT may also apply to a US management group that carries on activities in the UK that fall short of creating a UK PE; although, importantly, there is an exception where the UK investment manager exemption (IME) applies.

The IME is only applicable where trading is carried out in the UK through an agent. Accordingly, US management groups with UK investment advisors are only capable of satisfying the IME – and falling within the DPT exemption - where the UK advisor has discretionary authority to execute business. However, where a UK investment advisor does not have such authority, Her Majesty's Revenue & Customs (HMRC) has confirmed that a DPT charge is unlikely to arise in circumstances where the IME would have been met, if discretionary authority had been given.

A US asset management group that is potentially within the scope of DPT may have an obligation to make a notification to HMRC, unless it is reasonable to assume that no charge to DPT would arise. A failure to comply with the notification requirements could result in a significant tax-geared penalty.

Scope and operation of DPT

DPT applies in two distinct situations:

1. Where a group has a UK company or PE and there is a tax mismatch as a result of an entity or transactions between connected companies that lack economic substance (the *entity/transaction mismatch test*); and

2. Where a non-UK company has artificially avoided having a PE in the UK, in circumstances where there is a tax mismatch and lack of economic substance, or there is a tax avoidance motive (the avoided PE test).

A "tax mismatch" will broadly arise where income, which might otherwise have been taxable in the UK, has been diverted to a jurisdiction with an effective tax rate of less than 15.2% (i.e. less than 80% of the UK corporation tax rate).

The test of "economic substance" asks whether the financial benefit of the tax mismatch exceeds the other financial benefits of the arrangements, whether the contribution of staff in the low-tax jurisdiction provides economic value, and whether it is reasonable to assume that the transaction was designed to secure the tax reduction.

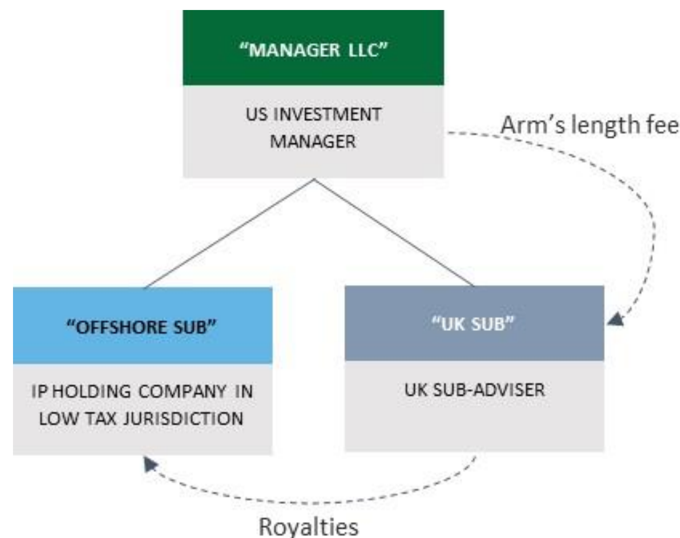
A "tax avoidance" motive exists where the main purpose or one of the main purposes of the arrangements is to avoid or reduce a charge to UK corporation tax.

There are a number of exemptions from DPT; most notably for small and medium sized enterprises (applying the EU definitions), financing arrangements and, in relation to the avoided PE charge, where UK-related sales revenue or expenses fall below certain thresholds. As noted above, there is also an exception to the avoided PE test where the IME conditions are satisfied.

Where it applies, the charge to DPT is 25% of "taxable diverted profits" plus interest. The tax can be calculated by reference to alternative arrangements that it is just and reasonable to assume would be substituted for the actual arrangements. In the case of an avoided PE, the "alternative arrangements" assume there is an actual PE in the UK (and the usual rules for attributing profits to PEs are applied).

A company that is potentially within the scope of DPT is required to notify HMRC within three months of the end of the relevant accounting period. This is subject to a number of exceptions, for example where it is reasonable to conclude that no DPT charge would arise for the current period, or where the business has already provided sufficient information to HMRC regarding the potential DPT liability.

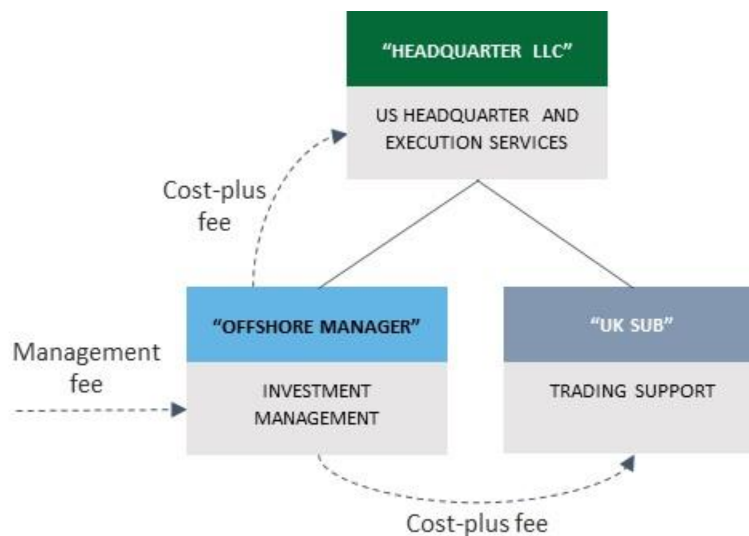
Example 1: entity/transaction mismatch test



The key questions are whether there is a tax mismatch as a result of an entity or transaction that lacks economic substance, and whether any exemption from charge applies.

- *Tax mismatch:* Royalties are tax deductible for UK Sub and subject to a low (or zero) rate of tax for Offshore Sub. Accordingly, a tax mismatch may arise.
- *Economic substance:* Depending on the circumstances, there may be insufficient economic substance, for example if:
  - It is not demonstrated that Offshore Sub, or the transaction through which the IP is provided to UK Sub, was expected to add significant economic value;
  - The income attributable to the ongoing functions of Offshore Sub's personnel does not exceed the other income attributable to the transaction; and/or
  - The royalties exceed an arm's length rate (in which case it may be reasonable to assume that both the transaction between UK Sub and Offshore Sub and the involvement of Offshore Sub were designed to secure a UK tax reduction).
- *Exemptions:* If Offshore Sub and UK Sub are both SMEs, an exemption from DPT may apply. However, in applying the SME tests, it may be necessary to consider the group as a whole (and, potentially, the funds).

Example 2: Avoided PE test



The key questions are whether the group has avoided having a PE in the UK, whether there is a tax mismatch and lack of economic substance or a tax avoidance motive, and whether any exemption applies.

- *Avoided PE:* If Offshore Manager or the fund is trading in the UK through the activities of UK Sub, but the IME conditions apply (such that UK Sub is not treated as a UK PE), there should be no avoided PE. If there is trading in the UK through UK Sub and the IME does not apply, there may be an avoided PE (assuming the group is not already treating UK Sub as a UK PE).
- *Tax mismatch:* Because the management fees are untaxed (or subject to low tax) and would have been subject to UK tax if attributed to UK Sub, a tax mismatch may arise.
- *Economic substance:* Depending on the circumstances, there may be insufficient economic substance; for example, if UK Sub provides the majority of the economic value of the management services.
- *Tax avoidance motive:* The specific facts and circumstances will need to be considered to determine whether arrangements are in place one of the main purposes of which is to avoid or reduce a charge to UK corporation tax.
- *Exemptions:* If Offshore Sub and UK Sub are both SMEs, an exemption from DPT may apply. An exemption may alternatively apply if the UK-related sales revenues of the group do not exceed £10m, or the UK-related expenses do not exceed £1m.

United Kingdom:

UK tax governance framework for US managers

Background

US asset managers with subsidiaries in the UK need to be aware that corporate tax governance and risk management arrangements in the UK are under an unprecedented level of scrutiny. HMRC business risk reviews now encompass tax strategy, tax governance and tax risk management. These factors are increasingly significant in determining the risk ratings HMRC applies to tax payers.

Thus far, 2017 has seen many groups in the UK preparing and publishing Tax Strategy statements for the first time, as well as the enactment into law of the new Corporate Criminal Offence which targets the failure to prevent the (already criminal) facilitation of tax evasion. In addition, HMRC have signaled their increased focus on the Senior Accounting Officer (SAO) rules by publishing new guidance on what constitutes "reasonable steps" in respect of an SAO's main duty; heightened levels of scrutiny around how SAO's discharge their responsibilities; and increased penalties.

Tax Strategy Disclosures

For many US asset managers with operations (whether structured as a corporate subsidiary, partnership or even branch) in the UK, publishing a UK tax strategy is now a requirement. This is the latest development in an international trend towards increased tax transparency and higher standards of tax governance and risk management.

Broadly, the requirement applies to:

- UK registered companies, partnerships or permanent establishments with a turnover of £200 million or more, or gross assets of £2 billion or more; and
- Multinational businesses with any operations (regardless of size) carried out through UK companies or permanent establishments with a consolidated turnover of €750 million or more.

The precise scope of the requirement can be more nuanced, particularly for fund structures and groups with partnerships in their structure, so it is important to assess carefully whether potentially affected businesses are within scope.

As part of the requirement, organizations must publish information on (i) risk management and governance; (ii) their attitude to tax planning; (iii) tax risk appetite; and (iv) their approach to working with HMRC.

While publishing a UK tax strategy may sound straightforward, it is in reality merely the 'tip of the iceberg', as boards seek to understand and influence how their company's taxes are governed and controlled. This often leads to the development of a formal tax control framework. Businesses should therefore be mindful of the time it takes to secure the appropriate internal approvals and input when considering their timetable for publication. For businesses with calendar year ends, **the deadline for publishing their UK tax strategy is December 31, 2017.**

There are penalties for not publishing a UK tax strategy correctly and on time.

Corporate Criminal Offense

The Criminal Finances Act 2017 creates two new criminal offenses for any 'relevant body' (a corporate or partnership) which fails to prevent the criminal facilitation of tax evasion by its 'associated persons'. The offenses, which differ only slightly, relate to the failure to prevent the evasion of UK and non-UK tax respectively. Evasion of tax is the illegal failure to declare all income, profits and gains and to pay all tax due. (Failed tax planning which is successfully challenged by a tax authority, but is not illegal, is not tax evasion).

There are three stages which must all occur for either offense to have been committed:

- **Stage 1**: Criminal evasion by a taxpayer (either individual or legal entity) under existing law, whether or not in the UK
- **Stage 2**: An 'associated person' of a 'relevant body' (company or partnership), knowingly facilitating the evasion
- **Stage 3**: That 'relevant body' failing to prevent its 'associated person' from committing the act of facilitation

The offense is one of strict liability: if stages 1 and 2 occur, the 'relevant

body' will have committed the new corporate offense unless it can show that it has implemented (and in due course, maintained) 'reasonable prevention procedures'.

US asset managers need to think in global terms, as the UK offense has extraterritorial reach, in that it relates to the facilitation of UK tax evasion, *irrespective of where in the world the facilitation occurs*. The offenses are aimed not only at UK tax but also at non-UK taxes, provided the facilitation has a *sufficient UK nexus*. For example, the declaration of foreign taxes by an offshore fund will be within the scope of the non-UK tax offense where a fund manager has UK operations.

"Reasonable prevention procedures" are not precisely defined. However, there are six key principles set out in HMRC guidance which the Government considers should inform prevention procedures put in place by 'relevant bodies':

- **Risk assessment -** Undertaking a comprehensive assessment of risk
- **Proportionality –** Implementing practical procedures that reflect the nature and complexity of the business
- **Top level commitment -** Senior management demonstration of commitment to the principles
- **Due diligence -** Performing due diligence procedures in respect of 'associated persons'
- **Communications and training -** Embedding policies effectively throughout the organization
- **Monitoring and review -** The monitoring, reviewing, and where necessary improving, by the 'relevant body' of its prevention procedures

While HMRC acknowledges that it will take more time than is available to fully implement 'reasonable prevention procedures', HMRC nonetheless expects the following to be in place *by September 30, 2017*:

- Top level commitment from senior management
- Demonstration of a clear commitment to compliance (i.e. completion of a risk assessment)
- An implementation plan for tackling risks and issues arising from the risk assessment

There are material implications for any 'relevant body' found guilty of the new offense. These include:

- a corporate criminal conviction
- unlimited penalties
- significant reputational damage; and
- potential material sanction from regulators

Senior Accounting Officer

Under the Senior Accounting Officer (SAO) legislation, introduced in Finance Act 2009, a senior officer of the company, most often the CFO, is required personally to certify (as SAO) that their company systems are fit for purpose in respect of reporting certain UK taxes by UK incorporated entities. The SAO is subject to a personal penalty if he or she fails to do this or HMRC feels that they haven't exercised their duties appropriately. This covers the complete end-to-end accounting process, from initial capture and recording of transactions in financial systems through to submission of tax filings. In addition to issuing revised and more detailed guidance, HMRC has increased its policing of SAO compliance and we are seeing an increase in the number of penalties being issued.

In conclusion, irrespective of whether a SAO is based in the US or UK, or whether UK operations encompass managing European assets or are focused on distribution activities only, the UK's increased focus on tax governance and risk management needs to be taken very seriously.

United Kingdom:

Anti-avoidance: Impact of the new disguised investment management fee rules on US managers with UK operations

Background

The disguised investment management fee (DIMF) rules were introduced in 2015 as part of a wider reform of the tax treatment of management fees and performance fees/carried interest in the UK. DIMF purports to target prior arrangements that sought to convert management fee income into non-taxable amounts or capital returns for principals engaged in a fund management business.

The DIMF legislation witnessed rapid expansion in scope during successive re-drafts during 2015/2016 and the views of the UK tax authorities, Her Majesty's Revenue & Customs (HMRC), on its application are born out of the near 100 pages of HMRC published guidance.

Scope of DIMF

The DIMF legislation bites on fee income that 'arises' to individuals that provide investment management services from the UK, where that fee income is not already subject to UK income tax (either as employment income or trading income) – the legislation treats such amounts as 'untaxed'. Where the DIMF charge applies, the relevant individual is liable to pay UK income tax and national insurance contributions (at 47%) on the untaxed amounts, as if the *individual is itself* carrying on a (separate) trade in the UK.

There are relatively broad exceptions from DIMF if the amount received is, in fact, a performance fee structured as a 'carried interest' or is a repayment of co-invest or a return on co-invest. The type of 'carried interest' that is excluded from the operation of the legislation is tightly prescribed.

The charge appears extra-territorial in nature, given that the charging provisions apply to both UK resident individuals that perform investment management services in the UK and outside the UK – as well as to non-UK resident individuals that perform services within the UK.

Common applications of DIMF to US-headed managers

Profit allocations to low taxed territories

US-headed groups with a global footprint may have operations (on the management group side) in a low tax or 'no tax' jurisdiction. Where fee income, generated in relation to the provision of investment management services, is earned by an entity in that low tax/no tax jurisdiction, the DIMF legislation might seek to tax it, if it has been generated by a UK person and the UK person can (in broad terms) enjoy the fee income, for example, because the person controls the offshore entity by virtue of board membership or share ownership.

Hedge funds, in particular, with US, UK and Cayman operations might have cause to consider the application of the rules where UK principals are rewarded out of profits allocated to the Cayman Islands. And it is to be noted that there appears to be no exemption from a UK income tax charge on management fees allocated to a low tax jurisdiction in circumstances where those fees have been priced to an arm's length standard – if the amount allocated offshore is 'untaxed' in the hands of UK residents, it is simply the case that DIMF may apply.

US groups with principals travelling to and from the UK

It is common in the investment fund context for US-headed groups with UK operations (either through a branch, subsidiary, or limited liability partnership) to see senior principals of the business travelling between the US and the UK and continuing to provide investment management services from that other jurisdiction (see example 1 below). Where senior US executives come to the UK to participate in investment committees, to research a potential investment opportunity or to meet with UK/European clients of the group, for example, the breadth of the DIMF legislation means that any carry or other amounts earned by the US executives (that are referable to services performed in the UK) potentially face a charge to UK income tax at 47%, notwithstanding that such amounts would ordinarily be taxed in the US; this is because those amounts would otherwise be 'untaxed' in the UK.

The breadth of the legislation would therefore appear to be a bit of a problem for US managers that send personnel from the US manager to do (some) business in London. The HMRC guidance on the application of DIMF suggests that the charge would

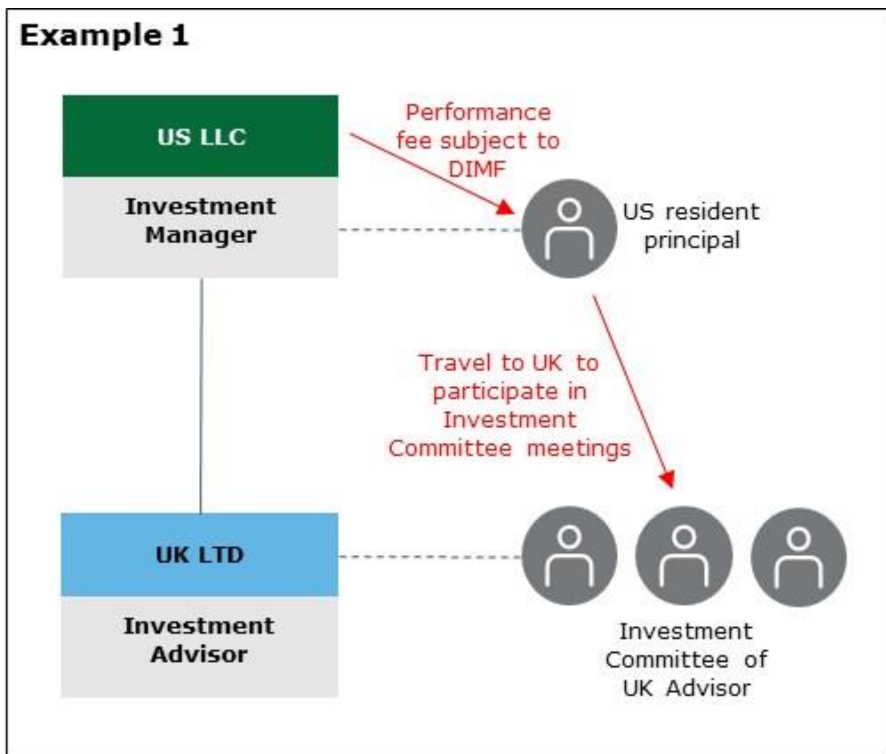
be unlikely to apply in the context of an individual that "very occasionally comes to the UK". An example in the guidance seems to suggest that 'very occasionally' might be limited to about three days per annum, but in truth, there is no relaxation of the charge to be found in the legislation.

HMRC consider in their guidance that, in a situation where an individual is likely to suffer double taxation, relief may be available under the terms of a relevant double taxation treaty. It is considered (by HMRC) that, as a generic matter, relief under a treaty may be available, provided the individual is not carrying out the 'DIMF' trade through a permanent establishment in the UK. It is not clear whether relief would be specifically available under the US-UK double taxation treaty and, indeed, every situation will need to be considered on its facts. It can indeed be relatively common for senior US individuals of US-headed management groups to be given unrestricted access to the office of the UK subsidiary/branch, which raises the risk that those individuals create a UK permanent establishment; if those individuals are performing 'investment management services' while in the UK, the potential DIMF charge needs to be a serious consideration.

If a DIMF charge does arise to a US individual and he/she is also subject to US income tax, consideration will need to be given to whether a foreign tax credit is available against the US tax [for example under Article 24 (Relief from double taxation) of the treaty].

Comment

There has been a landslide of tax reforms affecting the UK asset management industry over the past two years. Any asset management group with a UK platform, with principals moving in and out of the UK for business purposes, will need to assess the risk of this potentially penal, new charge to UK tax. The risk of double taxation and of unfunded UK tax charges is an unfortunate consequence of DIMF – and a consequence that falls on the principals of the business rather the business itself, perhaps making it all the more penal.



United Kingdom:

Transfer pricing for investment management businesses

Introduction

After the initial energy regarding the announcement of the OECD's Base Erosion and Profits Shifting (BEPS) project and the subsequent issue of a number of final reports, things appear to have quieted down. It is therefore natural to take a moment to consider what has actually changed in relation to the UK transfer pricing legislation.

This article focuses on the transfer pricing changes introduced by the BEPS project more relevant for cross-border asset managers, and considers what practical steps could be taken to respond to the changes in how the rules work.

The three areas we will focus on are:

- The changes to UK documentation requirements and disclosure of information;
- The updated wording regarding the basis for choosing an appropriate transfer pricing method; and
- Tax authority behaviors.

The new documentation standard

Updated transfer pricing guidance from the OECD includes the introduction of Country by Country Reporting (CbCR), and transfer pricing Master and Local File documentation. While most of the participants and contributors to the BEPS project have incorporated CbCR, the adoption of Master and Local File documentation has been less complete - the UK, for one, not having chosen to implement it for now.

A question often asked is whether this means there is no requirement to complete a Local File for the UK. This approach is particularly attractive when the UK operations of overseas-headed groups are complex (perhaps by virtue of the UK being a hub for both distribution and portfolio management activities) and, therefore, the Local File would be far from straightforward. While it is certainly true that the current UK legislation does not stipulate the preparation of a UK Local File, there are requirements to have evidence of arm's length pricing in support of the UK Tax Return, which often results in a local report. There exists the practical question as to whether asset management groups would prefer to maintain two levels of documentation (which may require annual updating), or alternatively to raise the level of documentation prepared for the UK to a consistent position with the OECD's recommendations, thereby removing the need to maintain two levels of separate documentation. Many within the industry are choosing to adopt the latter approach on practical grounds alone.

This pragmatic approach may be worth applying more widely (and perhaps globally) in order to help administer and comply with what are becoming global requirements; however the application of Master and Local File rules elsewhere may dictate whether such practical management is possible.

Replacement of "cost plus" with "fee splits"

Within the investment management industry there have been discussions on whether the use of cost plus or comparable uncontrolled price/transactions (CUPs/CUTs) methods are now 'dead' – with firms now needing to adopt a profit/fee split. The discussion originated from the wording in an earlier draft of the OECD guidance that suggested a higher level of comparability was necessary when applying comparables to determine intra-group pricing, and a softening of requirements for the profit split method. Transfer pricing policies based on cost plus and CUP/CUT comparables have historically been relatively common in the asset management industry and so the concerns are relevant, although the appropriate method continues to derive from the respective operational contributions of the parties.

More recent guidance from the OECD has, in effect, addressed some of these concerns. The guidance contemplates that the implementation of profit splits can often be very complicated and that all reasonable endeavors should be taken to adjust comparables in order to implement the more traditional pricing methods. However, it remains the case that profit or fee splits are useful in solving what may otherwise be unsolvable pricing problems, and can have some positive influences also (for example, better aligning income with costs within a group structure leading to

cash flow advantages). This is especially the case where expenses are not incurred consistently throughout the financial year, due often to significant bonuses accrued and payable to employees, as is often the case in asset management.

It is recommended to more closely monitor the appropriateness of the transfer pricing method applied given changes arising in interpretation of OECD Guidance and structural changes occurring in the industry or individual business.

Tax authority behaviors

Changes to guidance are one thing, but a key question is how are countries (including the UK) incorporating the proposals into local legislation and how are tax authorities applying it? Two areas considered below are:

- The use of comparables for benchmarking; and
- Attention to potential permanent establishment structures.

Comparables

As mentioned above, the use of comparables has historically been common in the investment management sector, primarily in the form of comparable uncontrolled prices/transactions to benchmark the split between asset management and distribution, but also, cost plus structures that seek to remunerate the more routine elements of the value chain. Increasingly, the process for selecting those comparables and the nature of the final set of observations, is subject to scrutiny. This is in light of the proposed changes under BEPS Actions 8-10 on Transfer Pricing. The approach is suggestive that tax authorities are expecting greater rigor to be applied to the selection of comparables, and consideration is given to amendments necessary to those comparables. Consequently, it is even more important to undertake and document a robust process in determining future comparables.

Permanent Establishments

The OECD, through the BEPS project, has recommended the adoption of a lower threshold for the creation of a permanent establishment (PE) of a non-resident. The OECD recommendation (in broad terms) is that a PE may be present where an agent plays a principal role in the conclusion of a contract between the non-resident and a customer (rather than having to bind the non-resident through the contract execution itself). The new definition of a PE and the fact that only certain countries have adopted it, has created a two-tier structure. The UK has, at this stage, chosen not to adopt the new definition. However, the ongoing global discussion regarding PEs means that there will be greater scrutiny on those structures that are close to the threshold. In addition, the UK's Diverted Profits Tax and its application to structures that have been designed to avoid a dependent agent PE is now much in focus – and substantially explains why the UK has not sought to adopt the new OECD PE definition. Regardless of the UK decision, many European jurisdictions have adopted the lower PE threshold. This could have an impact upon many US headed managers with UK portfolio management capability, but with a branch distribution network located in the European Union.

Nonetheless, the global attention on PEs (and the introduction of "diverted profits taxes" by countries like the UK and Australia) has encouraged tax authorities to ask more pertinent questions than in the past. As a result, many businesses have been reviewing existing structures and operational processes to understand the impact and adapt their models appropriately.

Conclusion

Some may argue that many of the changes proposed by the OECD are perhaps more subtle than was originally expected, but as noted above, the legislative changes are just the first stage. Tax authority implementation and interpretation are at least as important. Monitoring both the new guidance and its implementation going forward will therefore be critical.

United Kingdom:

Legislation introduced to counteract hybrid mismatches is potentially very wide reaching in application

Overarching principle of the new legislation

The overarching principle of the relatively new legislation is that adjustments will be made to UK corporation tax liabilities to counteract situations where there would otherwise be a:

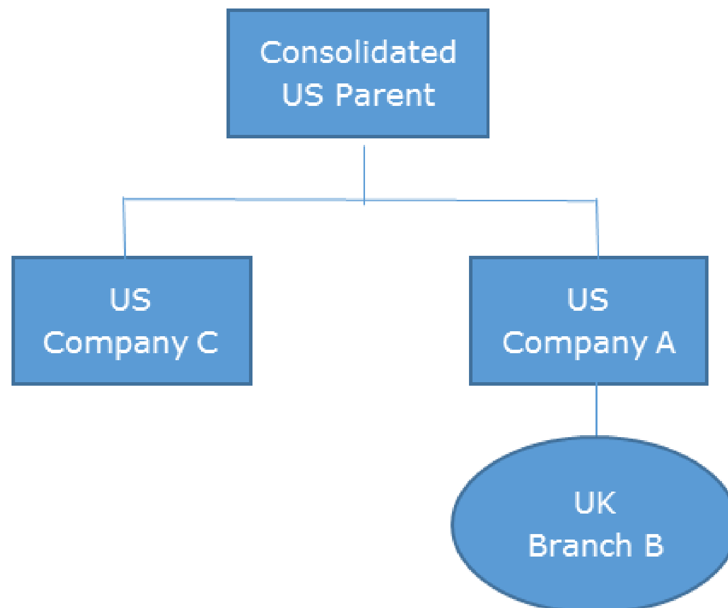
- tax mismatch created by a deduction for expenses arising in both of two territories (a "double deduction" mismatch); or
- tax mismatch created by a deduction arising in one territory with no inclusion of the income generated by that deduction elsewhere (a "deduction/non-inclusion" mismatch).

The legislation describes the circumstances under which a hybrid mismatch might arise. This includes:

Hybrid entities: mismatches may be attributable to the hybrid nature of entities (those that are treated as taxable persons under one territory's tax law, but as tax-transparent entities under another's); and

Companies with permanent establishments (PEs) outside their state of residence: mismatches may arise from PEs, either because payments to companies with a PE are not fully taxed in either the head office or PE territory, or because the PE territory permits tax deductions for actual or notional payments to the head-office territory that are not correspondingly taxed there.

Example: Consider a US Asset Manager Group with the following structure:



In the structure above Branch B could be either a UK permanent establishment ("PE") of US Company A or Branch B could be a UK legal entity that has elected to be disregarded from its owner for US federal income tax purposes. In either case, it will be treated as a branch of the US entity.

Branch B has third party costs, such as compensation to UK employees. The third party costs are "double deduction expenses" as the expenses will be deducted in the UK tax return

of Branch B and in the US tax return of Company A.

Key terms in the UK tax legislation

Under the UK legislation the double deduction amount may not be deducted unless it is deducted from dual inclusion income.

For a hybrid-entity dual inclusion income is defined as an amount that is both "ordinary income of the hybrid entity (Branch B) for that period for corporation tax purposes" and ordinary income of an investor (Company A) in the hybrid entity for a permitted taxable period for the purposes of any tax charged under the law of an investor jurisdiction.

In the case of a multinational company (such as a US entity with an actual UK PE), dual inclusion income is defined as amount that is both ordinary income of the company for that period for corporation tax purposes, and ordinary income of the company for a permitted taxable period for the purposes of a tax charged under the law of a territory outside the United Kingdom.

Ordinary income is a key concept in the hybrid rules. It is defined as income that is "brought into account, before any deductions, for the purposes of calculating the income or profits on which a relevant tax is charged ("taxable profits").

However, the definition of ordinary income is subject to the following caveat:

"But an amount of income is not brought into account for those purposes to the extent that it is excluded, reduced or offset by any exemption, exclusion, relief or credit-

(a) that applies specifically to all or part of the amount of income (as opposed to ordinary income generally), or

(b) that arises as a result of, or otherwise in connection with, a payment or quasi-payment that gives rise to the amount of income".

Areas of uncertainty regarding US consolidated federal tax returns

Scenario 1

The only income Branch B receives is from Company A, which could part of the external revenues that Company B receives. Branch B has income for UK tax purposes, the income from Company A. Branch B has no income for US federal tax purposes as the payment from Company A to Branch B is ignored. As a result, Company A does not have ordinary income and therefore there is potentially no dual inclusion income.

This matter, and whether the external income received by Company A can be taken into account, has been raised with the UK tax authorities.

Scenario 2

The above entities have the following income and expenses for UK and US tax purposes (as appropriate):

	Branch B	Company A	Company C
Income/ payment from Company C to Branch B	150	150	(150)
3rd party income received in UK	100	100	–
3rd party income received in US	–	40	20
3rd party costs	(200)	(200)	–
Profit/ loss	50	90	(130)

UK tax will be paid in the UK on the 50 of Branch B profits. This tax would be expected to be creditable in the US.

Company A and Company C are part of a US consolidated federal tax return. Under the relevant US regulations, it would be expected that the schedules to the consolidated return would include the results of Company A, 90, and Company C, (130).

The point at issue is whether the amount paid by Company C, which is recognized as income in Company A due to it being received by checked Branch B, is eliminated by the US consolidated return in such a way that there cannot be ordinary income.

Is the total taxable income in the US 310 (150+100+40+20)? (This being the sum of the external and internal amounts.) Or is the intra-group amount of 150 of income excluded, reduced or offset by the 150 of expense?

Guidance issued by HMRC

The anti-hybrid legislation took effect from January 1, 2017 and while HMRC issued draft guidance of 402 pages on it in December 2016 and updated draft guidance of 390 pages in March 2017, the point regarding income arising within a consolidated US tax group is not covered in the examples in that guidance. More updated guidance is expected from HMRC.

Next steps

US asset managers with structures and intra-group flows similar to the above will need to look carefully at their UK tax position. Before filing any tax return which includes a period after January 1, 2017, it will be important to analyze of the implications of the US consolidated filing regulations in the light of the wording in the UK tax legislation.

Contacts:

For additional information or questions regarding international tax developments, please visit http://www.deloitte.com or contact one of the following tax leaders:

Julia Cloud
National Managing Partner,
Investment Management Tax Practice
Deloitte Tax LLP
Tel: +1 312 486 9815
Email: jucloud@deloitte.com

Ted Dougherty
National Managing Partner,
Investment Management Tax Practice
Deloitte Tax LLP
Tel: +1 212 436 2165
Email: edwdougherty@deloitte.com

Thomas Butera
ITAMS Group Co-Leader
Principal, Deloitte Tax LLP
Tel: +1 212 436 3231
Email: tbutera@deloitte.com

Jimmy Man
ITAMS Group Co-Leader
Partner
Deloitte Tax LLP
Tel: +1 408 704 2674
Email: jman@deloitte.com

Deborah Anthony
Partner
Deloitte UK
Tel: +44 20 7303 2801
Email: danthony@deloitte.co.uk

Kevin Cummings
Partner
Deloitte UK
Tel: +44 20 7007 1184
Email: kcummings@deloitte.co.uk

Miles Humphrey
Client Service Executive – UK Desk
Deloitte Tax LLP
Tel: +1 212 436 6184
Email: milhumphrey@deloitte.com

Ivan Mullinax
Managing Director
Deloitte Tax LLP
+ 1 212 436 2275
Email: imullinax@deloitte.com

Robert Plunkett
Principal
Deloitte Tax LLP
Tel: +1 212 436 5261
Email: rplunkett@deloitte.com

Suzanne Tierney
Senior Manager – Washington National Tax
Deloitte Tax LLP
Tel: +1 212 436 4228
Email: sutierney@deloitte.com

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about for a detailed description of DTTL and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2017 Deloitte Development LLC. All rights reserved.