SLAUGHTER AND MAY

Slaughter and May Podcast
Tax news highlights: October 2020

Zoe Andrews	Welcome to the October 2020 edition of our Tax News Highlights Podcast. I am Zoe Andrews, Head of Tax Knowledge
Tanja Velling	And I am Tanja Velling, Professional Support Lawyer in the Tax department. Zoe and I will discuss the blueprints for international tax reform, published by the OECD on 12 October 2020, certain points around the expiry of the transition period for the UK's departure from the European Union and the judgment of the Court of Justice of the European Union in the United biscuits VAT case.
Zoe Andrews	Tanja, you watched the press conference and the OECD Talk Talks #17 at which the release of the blueprints were discussed. What were your main takeaways?
Tanja Velling	Presumably, you won't let me get away with saying that Pascal Saint-Amans's cat is fascinated by Zoom and Tax and likes to zoombomb OECD Tax Talks?
Zoe Andrews	Haha. No.
Tanja Velling	OK fine. I have three broad observations. The structure of the proposal has remained the same. A number of thorny issues remain open, and finally the level of complexities is staggering.
Zoe Andrews	So when you say the broad structure remains, the reform proposal is still made up of two pillars. Pillar 1 seeks to reallocate taxing rights and market jurisdictions, whereas Pillar 2 is intended to ensure a minimum level of effective worldwide corporation taxation.
Tanja Velling	Yes, that's right. But also the structure within the Pillars has remained broadly the same. Pillar One continues to have three main elements: • Amount A constitutes a new taxing right for market jurisdictions over a share of residual profits. These are calculated at group or business segment level and the new taxing right is an overlay on existing transfer pricing and nexus rules. • Then there's Amount B which works within the existing rules. A fixed return for defined baseline marketing and distribution activities is to be introduced. This would simplify the application of existing transfer pricing rules and enhance tax certainty. • Now regarding the third element. Those who have followed the evolution of the proposals may have wondered what happened to Amount C. Well, the term has disappeared, but the concept remains.

	Amount C was never really an amount in the same way as Amounts A and B, but a short-hand to refer to the dispute prevention and resolution process – and Amount C has effectively been re-branded accordingly.
Zoe Andrews	And Pillar Two?
Tanja Velling	Pillar Two has three main rules. Their order of application reflects what the Blueprint calls a “top-down” rather than a “bottom-up” approach. • First, we have the Income Inclusion Rule which can be understood as a type of controlled foreign company rule. The parent entity is required to bring into account its share of the income of each subsidiary in a low tax jurisdiction and tax that income to bring the effective taxation up to the agreed minimum level. The Income Inclusion Rule would be accompanied by a so-called Switch-over Rule. This would allow the parent to tax income arising in a permanent establishment which an applicable double tax treaty would otherwise require to be exempt from tax. • The second main rule is the Undertaxed Payments Rule. It would apply only to under-taxed income that is not already subject to additional tax under the Income Inclusion Rule. Entities in countries that have implemented the Undertaxed Payments Rule would tax a proportion of that income. The proportion would be determined, first, by reference to deductible payments made and, secondly, to net intra-group expenditure. • Finally, there is the Subject to Tax Rule. It would override applicable double tax treaties to permit source jurisdictions to apply a top-up tax, for example in the form of a withholding tax, to certain categories of payment that are considered to present a greater risk of base erosion. The additional tax would be taken into account in determining the effective tax rate for the purpose of the Income Inclusion Rule and the Undertaxed Payments Rule. So, in practice, the Subject to Tax Rule would take priority over the other two rules.
Zoe Andrews	And what’s still left unresolved?
Tanja Velling	Some significant questions around the application of both Pillars are still open. In respect of Pillar One, political agreement on the activities within the scope of the new taxing right has not yet been reached. Questions raised by the US in December 2019 around the application of Pillar One as a safe harbour are also unresolved. In respect of Pillar Two, the minimum rate has not yet been agreed, and it is unclear whether Pillar Two would apply in the US at all, or whether the US GILTI regime would be seen as an equivalent minimum tax.
Zoe Andrews	You also mentioned that the proposals were staggeringly complex.
Tanja Velling	Indeed. For instance, the application of the new taxing right alone is envisaged as a 10-step process in the flowchart at the end of the Pillar One Blueprint and its implementation will require a whole new loss carry-forward

	system which would presumably sit alongside domestic carry-forward regimes. Furthermore, domestic legislation alone is insufficient to implement either Pillar. Some form of multilateral dispute resolution convention would be required and, in respect of Pillar Two, another multi-lateral instrument to effect the required treaty changes could be needed. But then having said all that, taking a step back, it might be seen as an incredible feat, that any progress have been achieved at all if you take into account of the magnitude of the task. Think only about uniting the diverging political interests of the now 137 Inclusive Framework members and taking account the interest of the wider stakeholder community (during the 2019 public consultation on the proposal, over 150 written submissions, they ran to over 1300 pages were received from a wide range of businesses, industry groups, law and accounting practitioners). It is probably right to say that “a lower level of complexity was reasonably out of reach” as our colleagues Andrea and Francesco from BonelliErede commented on the European Tax Blog in respect of Pillar Two. Nonetheless, to my mind the question remains. Is the complexity worth it? And Zoe, I believe you have had a look at the OECD’s economic impact assessment.
Zoe Andrews	Yes I did and I find it really disheartening that the impact assessment for the complex, structural reform of the international tax rules shows the proposals as the least worse-case scenario. With or without reform, a decrease in global GDP is expected. However, the negative effect of the proposals on investment and economic activity is expected to be a less than 0.1% reduction in global GDP over the long term, which is not as severe as the loss of GDP expected in the counterfactual scenario where you have multiplying unilateral measures and ensuing disputes and trade tensions. At the start of the project there was the hope that any reform would be a significant improvement on what we already have. But it is not even clear who the winners and losers will be from the revenues which the reform is expected to generate. This is partly because no jurisdiction-specific estimates were published, and partly because behavioural changes resulting from the proposal may bring additional benefits that are not easily quantifiable.
Tanja Velling	So how much additional revenue is expected from the reforms?

Zoe Andrews	Pillars One and Two combined could increase global corporate income tax revenues by 1.9% to 3.2% (USD 50-80 billion), depending on various factors, including the final design and parameters of the Pillars. The lion's share of this increase is attributable to Pillar Two: expected direct revenue gains from the introduction of a minimum effective tax rate are in the range of USD 23-42 billion and a reduction in profit shifting is expected to raise USD 19-28 billion.
Tanja Velling	Does this take into account the amounts from the US GILTI regime?
Zoe Andrews	No – the assumption is the US GILTI regime will coexist with Pillar Two (although, as you mentioned, this is yet to be agreed) so these figures exclude any potential gains related to the application of Pillar Two by US multinational enterprises. Adding in the revenue gains of the GILTI regime would take the total effect to up to 4% of global corporate income tax revenues.
Tanja Velling	But it is important to note that the impact assessment may overestimate the revenue gains. This is because it does not take into account a number of factors that could lead to them being less than estimated. These would be: any decrease in MNE profitability because of COVID-19, and reductions in profit-shifting resulting from the implementation of the BEPs project, and the effect of changes to the US tax code made in 2017 or of certain provisions that may already allow jurisdictions to levy taxes on profits that would otherwise be subject to low levels of effective taxation (e.g. withholding taxes or controlled foreign company rules). And then what about the effect of the reform on investment decisions?
Zoe Andrews	Well the impact assessment concludes that where to locate an investment will be affected as non-tax factors will become more influential than tax rates in the choice of location. But it seems that the overall level of investment will not be significantly impacted. Although research has shown that multinational enterprise investment in a jurisdiction is negatively affected by effective corporation tax rate increases in that jurisdiction, large, highly profitable multinational enterprise groups, which are more likely to be impacted by the proposals, appear to be less sensitive to taxes in their investment behaviour than the typical multinational enterprise group. This means that increases in group-level investment costs as a result of Pillars One and Two may result in only a limited reduction in global investment levels. And this is why, overall, the negative effect on global GDP stemming from the expected increase in tax revenues associated with the proposals is estimated to be less than 0.1% in the long term. The Impact Assessment suggests that this may be offset by other less quantifiable channels, such as the positive effect of the proposals to increase tax certainty, the increased efficiency of global capital allocation, and avoiding the more damaging effect on global GDP which unilateral measures would have.

Tanja Velling	This is certainly a delicate balancing act – much like most aspects of our next topic, Brexit. In particular, we will discuss some points relating to customs, employee taxation and retained EU and domestic case law. Starting with customs. As may have been expected, arrangements in respect of Northern Ireland remain a thorny issue. While the movement of goods between the EU and Northern Ireland should continue unaffected, the UK government also wants Northern Irish goods to enjoy full unfettered access to the rest of the UK market. To this end, the Internal Market Bill included provisions designed to safeguard against any attempt on the part of the EU to impose restrictions on the movement of goods within the UK. But these include provisions which the EU considers would flagrantly violate the Northern Ireland Protocol, if they were implemented. It remains to be seen how – or indeed whether - this road block can be circumnavigated.
Zoe Andrews	Indeed. And then there is the issue of secondments which was covered in the October edition of HMRC's Employer Bulletin. There will be changes regarding national insurance and social security coordination in respect of UK workers seconded to the EU, EEA or Switzerland or vice versa. Broadly, current arrangements will continue to apply to anyone who begins their secondment before the end of this year. Thereafter, different arrangements will apply and HMRC will issue further guidance in due course. In respect of the movement of workers between the UK and Ireland, the bulletin, however, notes that a reciprocal agreement has been reached and security coordination will continue on the same terms.
Tanja Velling	Following the end of the transition period, there will be two types of retained case law – retained EU case law and retained domestic case law. Broadly, "retained EU case law" refers to decisions of the Court of Justice of the European Union. "Retained domestic case law", on the other hand, refers to decisions of the UK courts before the end of the transition period in relation to retained EU law. But which courts will be able to depart from each category of retained case law after the transition period? The UK government has published a consultation response concluding that the departure from retained domestic case law should be governed by the existing rules of precedent. The power to depart from retained EU case law, originally envisaged to be given only to the Supreme Court and the final court of criminal appeal in Scotland, will be extended to the Court of Appeal and other UK courts of equivalent level. The consultation response states that, in the Government's view, "extending the power at this level will strike the appropriate balance between the need for legal certainty and for timely departure from retained EU law".

	And, in a way, this leads us neatly to the discussion of a recent CJEU judgment. Zoe, why have United Biscuits' hopes of a VAT refund crumbled?
Zoe Andrews	I see you can't resist the pun either. The Court of Justice has held in the United Biscuits case that pension fund management services provided to occupational pension schemes are not within the VAT exemption for insurance transactions. This is bad news for United Biscuits and the other taxpayers with historic claims stood behind this case, but HMRC will be relieved not to have to pay out on historic unequal tax treatment claims. The trustee of the United Biscuits' defined benefit (DB) pension scheme claimed a refund of forty years' VAT, arguing that a (now historic) difference in VAT treatment of DB scheme management by regulated insurers and other persons infringed the principle of fiscal neutrality. Under the principle of fiscal neutrality, supplies of goods or services which are identical or similar must be taxed in the same way. The trustee of the United Biscuits' DB pension scheme argued that there was a breach of fiscal neutrality, given that regulated insurers benefited from an exemption not afforded to others. The trustee claimed a refund of forty years' VAT paid on management fees to non-insurers which it argued should have been exempt. The Court of Justice agreed with the Advocate General that the investment management activities could not be classed as insurance transactions as there was no indemnity for risk which is an essential element of an insurance transaction. Whilst unsurprising, the decision will be a blow to United Biscuits and other claimants in a similar position, as the historic unequal treatment will be allowed to stand.
Tanja Velling	And now onto some anticipated developments – other than a further statement of support for the OECD's tax reform work by the G20 around their summit in November. • On the 26th of October, the Supreme Court will hear Rosendale Borough Council's appeal in the Hurstwood Properties case on the question whether, in applying the business rates legislation in respect of an alleged avoidance scheme, certain leases can be disregarded or the tenant SPVs' corporate veil be pierced. • Also on the 26th of October, the Upper Tribunal will hear the appeal in the Gallaher case on conforming interpretation. The First Tier-Tribunal had decided that a tax charge in respect of an intra-group asset transfer from a UK to an EU group company had to be disapplied. An instalment payment regime could not be read into the legislation to conform it to EU law.

	A differently constituted tribunal in the Panayi case reached the opposite conclusion in respect of a different tax charge and read an instalment payment regime into the legislation. The Upper Tribunal is scheduled to hear the appeal from that decision in around a year's time. • On the 12th of November, we expect the judgment in the European Sonaecom case. It is a VAT case concerning a holding company's ability to recover input tax. According to Advocate General Kokott, "In these proceedings the Court will, in particular, have to clarify what effects the change from the planned activity to the actual activity has on the deduction of input tax." It remains to be seen whether the Court will in fact provide the required clarification.
Zoe Andrews	That leaves me to thank you for listening. If you have any questions, please contact Tanja or me, or your usual Slaughter and May contact. Further insights from the Slaughter and May Tax department can be found on the European Tax Blog – www.europeantax.blog. You can also follow us on Twitter - @SlaughterMayTax