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GREAT INVESTOR INSIGHTS

Aggressive tax practices in UK inbound investment: careful navigation in choppy waters

Surveying the landscape

Corporate tax planning and compliance has seen a seismic and irreversible shift in climate over recent years; specifically, a metamorphosis from a focus on maximising shareholder value and profit, to concepts of corporate responsibility, paying one's "fair share" and safeguarding reputation. Multinational enterprises, in particular, are under close scrutiny from tax authorities and subject to an ever-increasing arsenal of anti-avoidance measures and, potentially, criminal investigations to tackle perceived tax avoidance.

The shift has been fuelled by a number of global developments and initiatives, and from many fronts. In large part, these reflect a political response to shifting economic fortunes and technological advancement. The OECD's Action Plan on base erosion and profits shifting (BEPS), in particular, has led to a number of significant global tax developments, and its ramifications continue. The genesis is multifactorial, but the outcome is clear. Tax strategy is no longer a discrete and mundane financial preoccupation, but a key facet of mainstream boardroom strategy, commanding considerable resources in terms of budget and management time.

In parallel, increasingly agile globalisation and (recently) very high levels of available investment capital mean that jurisdictions compete for inbound investment and provide fiscal incentives to encourage this. However, in the current tax climate, structures viewed as over-engineered are vulnerable to attack.

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Potential risks

Businesses must, therefore, assess the risk and consequences of ambitious tax positions being challenged by tax authorities.

Challenge on technical position: the anti-avoidance arsenal

A first concern may be that a tax authority challenges the taxpayer's position on a technical basis. In the UK, as in most other developed jurisdictions, the tax code is well endowed with provisions and principles designed to ensure that the rules cannot be used to confer advantage where none was intended. These include targeted anti-avoidance rules, purposive rules of statutory construction and a general anti-abuse rule.

In a cross-border context, there are likely to be additional transfer pricing considerations, particularly for highly leveraged positions, thin capitalisation issues and diverted profits tax concerns. In addition, the BEPS project has introduced wide-ranging anti-avoidance provisions into hundreds of double tax treaties through the unprecedented mechanism of the multilateral instrument (MLI on BEPS).

The substantive tax rules are supported by a vast array of disclosure obligations and information sharing regimes. These include the disclosure of tax avoidance schemes (DOTAS) regime, applicable across the range of UK taxes, and DAC6, the EU cross-border equivalent (although now reduced in scope in the UK). Multinationals are also subject to CRS, FATCA and country-by-country reporting requirements. The UK government is currently also consulting on new measures to require large businesses to disclose uncertain tax positions. The rules are further supported by measures such as a requirement on large business to publish annual tax strategies and the personal liability of senior accounting officers for certain companies' tax accounting arrangements. A series of arrangements between jurisdictions imposes real time automatic cross-border information exchange between tax authorities.

Interest and civil penalties

HMRC is entitled to impose penalties on taxpayers in a wide range of circumstances, including failure to submit returns or inaccurate returns. The level of penalty can depend on whether the taxpayer's conduct has been innocent, careless or deliberate. Quantum may also be affected by subsequent taxpayer behaviour. For example, penalties may be reduced for unprompted disclosure and taxpayer co-operation; conversely, penalties may be increased where there has been deliberate concealment. Penalties may be further increased where the error relates to non-UK jurisdictions. A sliding scale applies, so that higher penalties can be imposed where non-compliance relates to a jurisdiction that dœs not share information with the UK.

These penalties, combined with interest charges imposed to reflect late payment of tax, can quickly add up to significant sums. A further, recent feature is that it is becoming common for penalties to be suspended in exchange for companies contractually agreeing with tax authorities to abide by even more onerous compliance, transparency and disclosure obligations than is required by law.

Costs of investigation and litigation

The costs of an investigation or audit, both in terms of professional advice and management time, are often unpalatably high, and these should always be borne in mind. In a tax context, these costs can be particularly high, in part because the process is often very lengthy. For example, there are often very protracted discussions with HMRC before it can be said, with any clarity, that a matter has become a dispute. This delay often increases the difficulties and costs associated with any subsequent litigation. Evidential burdens, in particular, may be more difficult to discharge. Witnesses may no longer be available, recollections are likely to be less clear.

In the context of disputes under a double tax treaty, it is often contemplated that issues should be resolved under a mutual agreement procedures (MAP). This process is itself lengthy and there is no certainty that a resolution will be reached, meaning that the parties may then need to proceed to further litigation, leading to further expense, uncertainty and delay.

Taxpayers are, therefore, well advised to consider these potential future costs in reaching a decision on any investment structure.

Criminal investigations

The possibility of a corporate tax position leading to criminal prosecutions is something of a worst possible case scenario, but it can certainly happen, as the fallout from the German cum/ex investigations demonstrates.

In the UK, there are a series of possible offences when HMRC suspects criminal behaviour. These include cheating the public revenue (a common law offence), evasion of income tax, VAT fraud, and fraudulent evasion of duty. For individuals convicted of cheating the public revenue, the maximum sentence is life imprisonment although, in practice, sentences fall well below this. Specific sentencing guidelines apply to revenue offences for individuals and corporations.

The UK also has a series of strict liability criminal offences (in relation to which the prosecution is not required to prove intention on the part of the defendant) such as failure to prevent the facilitation of tax evasion offences (Criminal Finances Act 2017) and failure to declare offshore income and gains (Finance Act 2016). HMRC has gone on record recently to state that it is doubling its efforts to catch tax evasion and that, as a result, it intends to pursue more criminal investigations.

Reputation

In the current climate, it is often the question of reputation that may be the most significant concern for a business in determining its appetite for tax risk. The reputation of a business may affect the credibility of its business and its relationship with customers and tax authorities. Customers are increasingly discerning about the flavour of businesses with which they will deal. For an increasing number of sectors, perception is all, or at least nearly all. For these businesses, safeguarding reputation is paramount.

Holding structures: a specific area of vulnerability

For multinationals, holding structure arrangements, in particular, have a number of potential vulnerabilities which are often subjected to close scrutiny by tax authorities.

Residence and permanent establishments

One area of tension that comes up relatively frequently is whether a business's activities in a jurisdiction might be said to constitute either residence or a permanent establishment. In a UK domestic context, non-UK incorporated companies will be UK resident where "central management and control" in the UK is established. Sometimes the question of central management and control is unequivocal; however, often the position is more ambiguous, particularly recently in cases in which COVID-19 has restricted travel. Facts and context are all. Very small contextual nuances can lead to different results in otherwise similar factual positions. Similar difficulties can arise in determining the existence of a permanent establishment (which depends on the existence of a fixed place of business or a dependent agent).

Concepts of beneficial ownership

The concept of "beneficial ownership" appears in most bilateral double tax treaties based on the OECD model treaty. Broadly, the term is used to limit the entities entitled to benefit from favourable tax rates under the treaty to taxpayers that are beneficially entitled to (for example) income received from the party in the other resident state. Its purpose is to reduce possibilities of treaty shopping and tax avoidance.

Intermediate holding companies, in particular, may be at risk of being considered mere conduits, rather than enjoying beneficial ownership. Economic enjoyment and control will be important factors in any determination.

Transfer pricing

Transfer pricing rules require the imposition of arm's length pricing to certain arrangements between associated companies. For holding companies, the consequences of a transfer pricing adjustment may include a reduction in deductible interest where arrangements are considered to be over-leveraged.

MLI developments on treaty shopping

As mentioned above, the MLI on BEPS has effected, in an efficient and wholesale manner, a series of amendments to many existing double tax treaties. These include (as a result of BEPS Action 6 on treaty abuse) a number of measures in relation to treaty shopping. There are a number of potential iterations, but certain "minimum standards" include a statement of intention that treaty states intend to avoid creating opportunities for avoidance, a principal purpose test (a general anti-abuse rule based on the principal purposes of transactions or arrangements) and a limitation of benefits rule, which limits treaty benefits to certain entities.

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How best to navigate the waters?

Negotiating the tax code and managing compliance is increasingly complex and expensive, in terms of both financial cost and management time. The difficulties are exacerbated in the case of multinationals. Safe and acceptable tax strategies require integrated analysis of offshore as well as domestic tax regimes and the position must be continuously monitored for variations in law and interpretation. Further, multiple jurisdictions (effectively competing for taxable revenue) may take different views of the same fact patterns; mutual agreement procedures under bilateral tax agreements do not always yield agreement.

Combined with the fact that mistakes can be expensive (in terms of cost, management time and reputation), it is clearly important to get the tax investment strategy right. A detailed and exhaustive analysis of the applicable legal position is vital and, as ever, excellent, proactive communication and a good relationship with the revenue authorities is key.

For further information, please contact your usual Allen & Overy contact.

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