Caught in a diversion

Large Corporate

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Alastair Munro and Martin Lambert consider some of the potential problem areas associated with diverted profits tax

Key Points

What is the issue?

The government is introducing a new diverted profits tax from 1 April 2015 which is aimed at specific tax structuring carried out by large multinationals such as Google and Amazon but may also affect a wide range of other common group structures

What does it mean for me?

The new regime is very harsh because it will impose tax at 25% using a ‘pay now, argue later’ approach while taxpayers will have to notify HMRC within three months of the end of an accounting period if they believe they are potentially within the scope of DPT

What can I take away?

Companies should review their business structures as soon as possible to establish

The autumn statement announced a new diverted profits tax (DPT) applying at a rate of 25% from 1 April 2015. This is the Treasury’s response to concerns from various quarters that UK tax revenues are being increasingly eroded by multinationals’ tax planning strategies.

Some large, typically US owned, multinational enterprises have featured in the UK press recently because of the perception that their group structures have the effect of avoiding UK tax on profits of billions of pounds, made from trading with UK customers. This issue is not just confined to the UK, as highlighted by the Organisation for Economic Co-operation and Development’s (OECD’s) Base Erosion and Profit Shifting (BEPS) project.

This article outlines an understanding of why the government thinks DPT is necessary to restore tax revenues. It explores how it is proposed that DPT will

operate, based on the draft legislation published on 10 December 2014, and considers some of the policy issues and potential problem areas associated with DPT.

Background and context

OECD BEPS project

The OECD, which promotes policies (including taxes) to improve the economic and social wellbeing of people across the world, began its BEPS project in 2013. Among other things, BEPS is focused on tax planning that exploits mismatches in tax rules to shift profits to low tax regimes with little economic substance.

The OECD is comprised of 34 member countries, including many G20 members such as the US, UK and the EU. The BEPS project is publicly endorsed by the G20, which also includes non-OECD member countries such as Brazil, India and Russia.

In the meantime, the UK government has taken the proactive step of introducing a first wave of domestic legislation aimed at tackling DPT before the BEPS project is complete.

Existing UK tax rules

To understand DPT, it is first necessary to consider how the current rules operate.

UK tax analysis

Under CTA 2009 s 5(2)–(3) and s 19 et seq and the business profits article in the UK's double tax treaties, a non-UK resident company is only within the scope of UK corporation tax on its profits from those trading activities attributable to a UK permanent establishment (PE), as defined at CTA 2010 s 1141 et seq and the PE article in the relevant double tax treaty.

A notable exception is where the UK presence of a non-UK resident company is limited to preparatory or auxiliary activities (CTA 2010 s 1143). This allows a fixed place of business, such as a warehouse, to be maintained in the UK for the storage, display or delivery of goods in the UK belonging to the company, without creating a UK PE. There is a similar rule in the PE article of most double tax treaties.

A PE also exists if the company has an agent in the UK which has and habitually exercises an authority to do business on its behalf. HMRC's position, until now, has been that a foreign company selling goods over the internet to UK customers via a UK website does not have a UK PE, whether or not it maintains a UK server (INTM266100).

In contrast, the existing OECD Model Commentary on Article 5 considers that a server, as opposed to a mere website, represents a PE if the computer equipment is fixed at a specific location in a territory. In either case, this is a very narrow and, arguably, old fashioned view that is no longer in step with modern business practice.

Additionally, a foreign company may engage a related UK company to carry out sales support for its UK customers. The UK company will not itself enter into the sale of goods; and it will receive a service fee of a fraction of the overall profit made by the foreign company from UK sales.

Foreign tax analysis

To make sales with UK customers, some multinationals use trading subsidiaries resident in a low tax jurisdiction, such as the Republic of Ireland, where the tax rate on trading profits is only 12.5%. The profits may be further reduced by royalty payments, for example, for the right to use brand names, to another related company resident in a country with an even lower tax rate. Hence, even if HMRC successfully argued that there is a PE under existing rules, its profits are reduced by the royalties and the overall effective tax rate on profits related to UK sales remains extremely low.

The tax structuring does not end there. The US parent company may benefit from exemptions to the US controlled foreign company (CFC) rules (the Subpart F regime), applying to the third-party sale of goods (for the foreign sales company); and to same-country income (for the IP company). Under these rules, no US tax is payable until the profits are repatriated to the US. A typical structure is illustrated in ***Table 1***.

Table 1 – Summary of tax structure

Existing anti-avoidance approach

Since neither the trading company nor the intellectual property company are UK owned, they will not be subject to UK CFC rules. The foreign enterprise will argue

that its transfer pricing policies are robust. Challenging such structures using the UK GAAR is difficult, since they rely on widely accepted international tax principles.

Other tax structures perceived as abusive

Other structures targeted by the DPT may involve transfers of IP by UK parented groups to low-tax jurisdictions with little business presence, followed by a licence back to the UK for tax deductible royalties. The UK payer can self-assess; there is no UK royalty withholding tax based on the applicable double tax treaty (see ITA 2007 ss 911–913), so immediate HMRC scrutiny is impossible.

HMRC guidance and public comments suggest that structures involving leasing, property or captive insurance may also be caught by the DPT.

Government’s perspective

In spite of recent efforts to make the UK more attractive to foreign businesses, such as the reduction of the corporation tax rate to 20%, combined with more business friendly CFC rules, the UK government is keen to block perceived abuses. At a joint Treasury and HMRC DPT open day held in January, the DPT rules were presented as being necessary because other territories (that may already have strong anti-abuse measures) cannot be relied on to defend the UK tax base even once BEPS is complete.

By way of analogy, civil law countries usually have an abuse of law doctrine, meaning that acts disguising either the generation or the transfer of profits are ineffective. Civil liabilities resulting from tax avoidance cases or abnormal acts of management can include criminal penalties for company directors. Also, the US has recently asserted its taxing rights more vigorously with the Foreign Account Tax Compliance Act (FATCA) in a bid to reduce tax avoidance.

DPT mechanics

The DPT legislation appears to have been drafted to override existing tax rules, in particular because DPT is designed to be entirely separate from UK corporation tax.

Main heads of charge

The rules contain two main heads of charge. The first catches a non-UK resident company if there is UK activity carried on by another related entity on its behalf; and if there are contrived arrangements to avoid the creation of a UK PE through the use of a foreign company to supply goods or services to UK customers. Also, either or both a ‘mismatch outcome’ condition or a ‘tax avoidance’ condition must apply.

The second head of charge applies if a UK-resident company (or non-UK resident company trading in the UK through a UK PE) is involved in arrangements whereby profits are diverted from the UK to another related entity (usually based in an overseas territory, though it could equally be UK-based), resulting in an effective tax mismatch outcome where the related entity has insufficient economic substance.

The approach involves:

- calculating any increase in tax deductible expenses, or any reduction in the taxable income of the foreign entity that has avoided a PE in the first head of charge, or of the UK-resident company in the second head of charge;
- comparing these amounts with any increase in the other party’s tax liability (which can include foreign or UK tax); and
- if this calculation produces a positive number, there is a tax mismatch outcome, unless the tax paid by the second party is at least 80% of the UK tax the first party is treated as avoiding.

Arrangements are treated as having insufficient economic substance if the tax reduction above broadly exceeds any non-tax related financial benefit, and if it is reasonable to assume that the arrangements were designed to secure the tax reduction. The legislation postulates that this reasonableness test can still apply even if there are also commercial motives, thereby imposing a high burden of proof on the taxpayer.

Additionally, the insufficient economic substance test can be applied to a single transaction or to a series of transactions or situations where the economic value contributed by an entity’s employees is less the financial benefit of the tax reduction.

The tax planning arrangements which avoid a UK PE (as described above) therefore fall within the first head of charge. Arrangements where IP is transferred abroad to a group company with little commercial substance and licensed back fall within the second head of charge.

Exemptions

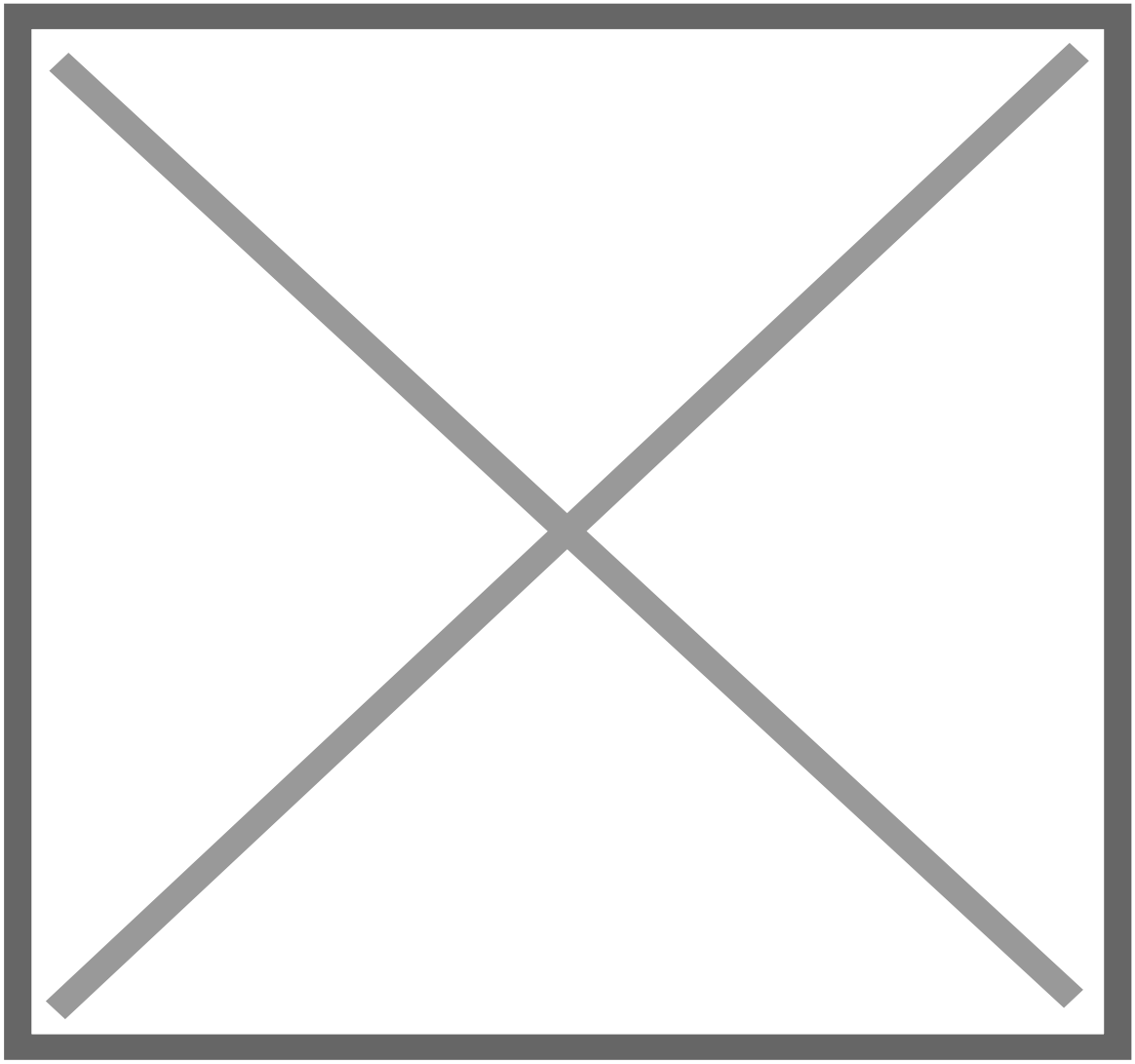
SMEs are excluded, as are deemed UK PEs, if the UK sales are no more than £10 million. Further exemptions relate to arrangements involving a non-related party independent agent or a connected party independent agent where the normal independent broker, investment manager or Lloyd’s agents exemptions from UK PE status apply.

Transactions involving only loan relationships are also excluded; for example, the finance company exemption in the UK CFC rules is not overridden. However, this exclusion will be revisited once the OECD has completed its work on BEPS Action 2 (hybrids) and Action 4 (interest deductions).

Administration and collection of DPT

A taxpayer must notify HMRC within three months of the end of the relevant accounting period that it is potentially subject to DPT. The process in the diagram below is then followed (see ***Table 2***).

This is effectively ‘a pay now, argue later’ system, with DPT potentially due less than six months from the accounting period end. Along with the 25% tax rate, this confirms DPT’s function as a deterrent, as the taxpayer is worse off than if they had not done the tax planning or, it seems, had the correct transfer pricing.



DPT calculation

HMRC will make a provisional DPT calculation to include in a notice. This can be adjusted subsequently by the issue of a supplementary charging notice or an amending notice during the 12-month review period, on the basis of information received from the taxpayer.

The calculation under the first head of charge follows a just and reasonable approach, based on normal corporation tax principles for UK PEs. The starting point is the amount of sales generated by the UK sales activity. The provisional calculation includes an automatic disallowance of 30% of expenses, such as royalties, that would be taken into account for corporation tax purposes if there was an actual UK PE. HMRC say this reflects their practical experience that transfer pricing of such

expenses is typically overinflated.

The second head of charge also considers what would happen in the absence of the tax planning arrangements, with similar ‘inflated’ expenses rules applying. Payments to affiliates, such as royalties, can be adjusted downwards following transfer pricing principles. They can also be disallowed completely if HMRC consider that, in the absence of the tax planning structure, the relevant IP would be held from the UK instead. A just and reasonable outcome may also involve the UK company being deemed to receive additional income, such as royalty streams.

Political commentary

A parliamentary debate in January indicated support from other political parties, and suggesting they would not repeal the tax if elected. However, it also highlighted concerns over the practicality of the assessment and collection of DPT from overseas companies. This broad support for the proposed rules is perhaps only to be expected, given that there will soon be a general election.

Response from foreign governments

In December 2014, Australia announced it may also implement a ‘diverted profit’ levy. It has ordered reviews of the tax affairs of numerous multinational groups to see if they pay sufficient tax on Australian activities.

At their open day, the Treasury and HMRC suggested the US government’s reaction to DPT was ‘calm’. However, the United States Council for International Business (USCIB) says the DPT would, if implemented, ‘increase the likelihood of double taxation on companies, which will have a negative effect on cross-border trade and investment’.

What does business say?

Some business leaders have described DPT as a unilateral move that risks undermining the global BEPS effort. However, some SMEs believe there should now be a more level playing field for all companies (large and small) in the UK and that DPT goes some way to address this.

The ACCA describes the DPT rules as a ‘highly aggressive piece of legislation’, pre-empting the OECD’s final BEPS recommendations and undermining the multilateral approach to BEPS that has been repeatedly called for by the OECD.

Pascal Saint-Amans, Director of the Centre for Tax Policy and Administration at the OECD, has said the UK’s plans for a DPT are interesting, but that they should only be undertaken at a multilateral level.

Can DPT be challenged?

The government sought advice from a leading tax QC to help ensure that DPT cannot be overridden by double tax treaties and that it is robust to a challenge under EU law.

DPT is not within the Taxes Covered Article of UK double tax treaties, but this article may still apply to taxes that are identical or substantially similar to UK corporation tax. There are certainly similarities to corporation tax in the way that DPT is calculated. HMRC also maintain that it is not obliged to grant treaty benefits in abuse cases, citing the existing Commentary to Article 1 of the OECD Model Tax Convention.

HMRC argue that the EU freedom of establishment principle (Art 49 TFEU) cannot apply to cases lacking economic substance, while not all situations to which DPT is intended to apply involve an EU counterparty. HMRC also consider that DPT is consistent with the international principle of fiscal territoriality, which is that a state may tax profits arising in its territory (see *Futura* C-250/95).

Following *Cadbury Schweppes* (C-196/04) and *Itelcar* (C-282/12), measures to combat tax avoidance are justified in the case of wholly artificial arrangements which do not reflect economic reality and which are undertaken with the sole purpose of avoiding tax.

However, many of the arrangements at which DPT is targeted are not wholly artificial, since they involve third-party trading. It could also be argued that it is not proportionate to impose tax at a higher rate than corporation tax and with a much earlier due date.

It is also unclear whether other jurisdictions will be prepared to assist HMRC with the implementation of DPT. The Assistance in the Collection of Taxes Article, along with mutual assistance procedures in many treaties, should mean that other jurisdictions will help HMRC to enforce the tax. Often, these treaty provisions apply to all the taxes levied by a contracting state and not just to the taxes listed in the Taxes Covered Article, but this point may be open to interpretation.

Compatibility with BEPS

BEPS Action 6 (tax treaty abuse) aims broadly to introduce changes to double tax treaties to clarify they should not be used to avoid tax. BEPS Action 7 (artificial avoidance of PE status) proposes amendments to Article 5 (PE definition) to bring a number of activities within the PE definition, including commissionaire arrangements and similar strategies. It also proposes, among other things, that a warehouse maintained in a territory for the storage, display or delivery of goods, eg for the purpose of internet sales, should constitute a PE.

However, as these work streams are not yet complete, it may be necessary for the DPT rules to be amended at a later stage, so that they are fully BEPS compliant, particularly as other jurisdictions begin to introduce their own DPT type rules.

In contrast, Action 14 offers protection to taxpayers from undue taxation. It clarifies that domestic anti-abuse measures should be the subject of the mutual agreement procedure (MAP) under a treaty and that tax payments should be deferred pending the MAP outcome. This indicates that HMRC’s view may be incorrect that DPT is outside the scope of double tax treaties and it may allow other jurisdictions to defend their taxpayers from UK DPT.

Pending the outcome of BEPS, there is a risk of retaliation from other jurisdictions through the introduction of parallel regimes. This could lead to multiple layers of taxation on the same profits without effective mechanisms for double tax relief, particularly if there is no MAP in place. This may cause serious barriers to cross-border business, not to mention a lack of trust between tax authorities and business.

Problems with the draft legislation

A key issue is that the rules are largely mechanical, relying heavily on the calculation of the tax reduction and the amount of any other financial benefit derived from the arrangements with no overriding principal purpose test (PPT). This does not seem compatible with the PPT in BEPS Action 6.

As there is no definition of ‘any other financial benefit’ and how this should be calculated, taxpayers have little certainty. This does not sit comfortably with the requirement for taxpayers to volunteer upfront the information that they may be caught by the rules.

There is at present no relief for DPT or CFC tax incurred in other jurisdictions, potentially leading to multiple tax charges on the same profits. Additionally, the legislation currently targets arrangements where the overseas tax on the profits considered to be diverted from the UK is less than 80% of the UK tax that would be payable. This threshold is inconsistent with UK CFC rules, which have a low tax exemption applying where the foreign tax is at least 75% of the UK tax on the same profits. In addition, the foreign tax threshold in the third-country PE measures in BEPS Action 6 is only 60%.

HMRC’s draft guidance on DPT requires further development, specifically in respect of providing more helpful worked examples, as most taxpayers are likely to fall somewhere between the extremes represented currently.

Other practical implications

Many taxpayers have already received clearance from HMRC that their CFCs are not caught by the CFC ‘Chapter 4’ rules for trading activities or have entered into advance pricing agreements (APAs) for certainty on the pricing of cross-border transactions.

It would be helpful if such situations could be exempted from DPT. However, HMRC were not receptive to this at their open day, because they consider DPT rules are still needed to recharacterise certain contrived planning structures. The only comfort HMRC could give at this stage was that companies which have adopted a transparent approach in relations with HMRC and fully disclosed their international tax structures are less likely to receive a notice.

DPT will also clearly increase the administrative burden placed on HMRC in taking on the role of ‘global tax policeman’, along with the compliance burden on companies which will first have to establish if they are caught by the rules.

Conclusions

Companies should review their business structures as soon as possible to establish if they may potentially be caught and determine what facts can be used to defend their position if necessary.

On 13 February 2015, the House of Commons Treasury Committee published its report on the autumn statement which concluded that the government’s decision to announce a unilateral DPT ahead of the conclusion of the OECD’s work should not be permitted to destabilise the international effort. It also concluded that the draft legislation was long and highly complex which is undesirable in itself and is likely to be a source of uncertainty.