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by Sol Picciotto

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FEATURED PERSPECTIVE

The U.K.'s Diverted Profits Tax: An Admission of Defeat or a Pre-Emptive Strike?

by Sol Picciotto

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The author explains the draft legislation for the U.K.'s proposed diverted profits tax and analyzes the relationship of the provisions to the reforms under negotiation through the BEPS process of the G-20 and OECD. Although the official U.K. position is that the proposals are not out of line, they clearly go beyond what has been proposed so far in the BEPS project. Hence, they seem to be either an admission that international agreement will not be reached that would satisfy U.K. concerns or an attempt to put pressure on the negotiators to do so.

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To the surprise of many, U.K. Chancellor of the Exchequer George Osborne proposed on December 3 a diverted profits tax (DPT) on multinational companies (MNCs). This seems to be an admission that the major effort for international tax reform — the OECD's base erosion and profit-shifting initiative, which the U.K. helped to get off the ground — may fail to ensure that MNCs can be taxed ''where economic activities take place and value is created,'' as mandated by the G-20 world leaders in the St. Petersburg Declaration of September 2013. It may also be a first strike in the complex negotiation process involved in completing the OECD's BEPS package and implementing the various interacting measures at international and national levels.

The implications of this proposal are hard to evaluate in full, not least because the contents of the proposal are couched in the mind-numbing legalese that is the specialty of Treasury legal counsel and parliamentary draftsmen. They have exceeded themselves on this occasion, and the explanatory notes provided are no clearer. Perhaps the aim is to shroud the implications of the controversial measures in logical and lexical semantics.

Another reason for the proposal's impenetrable complexity might be the need to make it as hard as possible to challenge the legal validity of the provisions under either tax treaty rules or EU law.[1] Indeed, the DPT might also be impugned on public law grounds for vagueness and giving excess discretion to officials to make decisions with major financial consequences for companies. If the intention is to provide protection from such challenges through technical complexity, the draft legislation succeeds surprisingly well. Its combination of complex and specific rules and general antiavoidance principles may be enough to protect it from invalidation under EU corporate mobility rules. No doubt equally ingenious minds will set to work to find legal grounds for a challenge, and may find clients interested in mounting such an attack. But such legal proceedings would take years to wind their way through to any sort of conclusion.

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[1]The DPT has been designed as a new tax, which HM Revenue & Customs believes is compatible with both tax treaties and EU law as an antiabuse measure.

This article must therefore be accompanied by a disclaimer: Despite having spent many hours struggling to decipher the proposal, I am not confident I have done so correctly, and certainly not completely.

Scope of the Tax

The tax is intended to apply to two types of cases.

The first is when a foreign company supplies goods or services to U.K. customers and activities take place in the U.K. in connection with such supply but in a way that it is ''reasonable to assume'' is designed to ensure that the foreign company has no permanent establishment in the U.K. Under current rules, taxable presence depends on having a PE, which entails some kind of physical presence.[2] The OECD decided some 10 years ago that a website or other ''virtual'' presence does not amount to a PE.[3] This decision gave a great advantage to Internet-based MNCs, but it is now being reconsidered under action 1 of the BEPS project by the Task Force on the Digital Economy.

If the measure stopped there, it would likely bring in billions, rather than around £350 million per year as estimated by the Treasury and HM Revenue & Customs.[4] It is nevertheless aimed at the big fish, since small or medium-size enterprises are exempt and the tax applies only if the total U.K. sales exceed £10 million. However, there are two other conditions in this type of case.

The first condition is that the foreign company must also be involved in ''mismatch'' arrangements with a related entity in connection with the supply of those goods or services. Mismatch arrangements are defined as transactions that increase the expenses or reduce the income of one related party and hence its tax liability and when the tax actually paid by the other related party as a result of those transactions is less than 80 percent of that reduction of tax liability resulting from the mismatch. It is important to note this tax saving includes non-U.K. taxes.

These mismatch arrangements must also involve ''insufficient economic substance,'' in at least one of three ways. The first is where a single transaction between related parties produces a tax reduction greater than any other financial benefit, and it is ''reasonable to assume'' the transaction was designed to do so. The second is where such a transaction is part of a series. The third is where a party to the mismatch arrangement contributes economic value to the transaction(s) that is less than the financial benefit of the tax reduction, and it is ''reasonable to assume'' that party's involvement was designed to achieve such tax reduction. Economic value is to be evaluated ''in terms of the functions or activities that the staff of that person perform.'' An arrangement may be considered designed to produce a tax reduction even if it is also designed to produce another objective.

The second condition applies if, in connection with the supply of goods or services to the U.K., it is reasonable to assume that ''arrangements are in place the main purpose or one of the main purposes of which is to avoid'' (U.K.) corporation tax. This is not subject to any other stipulations, so it is potentially quite broad. However, it is still focused on sales to U.K. customers organized in such a way as to avoid having a PE. It is perhaps a fail-safe provision anticipating the possibility of new types of avoidance schemes that fall outside the concept of mismatch.

The second type of case is where transactions between a U.K. resident company and a related entity involve mismatch arrangements between them, as well as insufficient economic substance, defined in the same way as for the first case. Hence, this does not require sales into the U.K. by a foreign company but applies to a company in the U.K. that exploits mismatches.

The first case can indeed be thought of as a ''Google tax,'' the label that the DPT has been given, since it aims at foreign companies avoiding tax on sales in the U.K. by not having a PE while also avoiding tax in other countries using arrangements such as the famous ''double Irish.'' The second case could be called a ''Starbucks tax,'' as it applies to companies that have a U.K. taxable presence but reduce their U.K. profits by transactions with a related entity in such a way that the U.K. tax reduction is not substantially matched by an increase in the tax liability of the related entity, if it has insufficient economic substance. This seems aimed at the equally well-known ''Dutch sandwich,'' widely used by many MNCs.

Confessing to the Revenue

Starbucks is relevant, too, because the proposals also require a company to 'fess up to the Revenue if it is ''reasonable to assume'' that it has generated taxable diverted profits. Starbucks, it may be recalled, offered voluntarily to ''forgo certain deductions'' so as to pay £20 million in tax over two years, as a result of the public outcry following the revelations of its use of the

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[2]In U.K. law, this is now under the Corporation Tax Act 2010, Part 24, chapter 2, which is based on and elaborates articles 5 and 7 of tax treaties.

[3]OECD Committee on Fiscal Affairs, *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5* (2000); and OECD, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for Taxing E-Commerce? Final Report* (2005).

[4]According to the Office of Budget Responsibility, the estimates are based on HMRC's analysis of actual taxpayer returns (evidence to the House of Commons Treasury Committee, Dec. 4, 2014). Google paid U.K. corporation tax of £20 million in 2013, while its total U.K. revenue is £3.6 billion; applying Google's worldwide profit rate of 20 percent, the 25 percent diverted profits tax would yield £180 million from this company alone. *See* Juliette Garside and Jill Treanor, ''Osborne to introduce 'Google tax,''' *The Guardian* [U.K.], Dec. 3, 2014.

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''Dutch sandwich.''[5] These proposals would make it compulsory for such a company to come clean and pay up. This would obviously save HMRC a lot of trouble but relies on companies being able and willing to decide that it is ''reasonable to assume'' that they have been dodging taxes. More likely the hope is that MNCs will be persuaded to restructure to avoid the threat of a 25 percent DPT, compared to the current standard corporate income tax rate of 20 percent.

The reliance on ''reasonable assumptions'' also extends to calculation of the amount of these diverted profits. For the first case (sales into the U.K.), they are the profits that it would be ''just and reasonable'' to assume would have been made if those sales had been attributable to the ''avoided PE'' in the U.K. It would be interesting to find out how this tax base will be defined in practice, although because it will likely be done by negotiation with individual companies, the specifics will probably be confidential. The gross sales revenue should be fairly easy to ascertain in most cases because these companies must be subject to U.K. value added tax registration under distance selling rules and data could presumably be taken from this source. The problem will lie in identifying the costs attributable to those sales, because many will be incurred outside the U.K. The simplest method would be apportionment based on consolidated accounts, but in view of the frequently expressed U.K. opposition to such an approach, it is unlikely to be accepted explicitly. The data to be made available in the country-by-country reports resulting from the BEPS action plan might also be helpful, but again the U.K. government would be reluctant to use them for this purpose.

For the second case, the taxable profits are, less contentiously, to be determined by applying U.K. transfer pricing rules to the profits transferred by the mismatch arrangements.

However, different and even more complex rules specify how the ''designated'' HMRC officer should arrive at a ''best estimate'' when issuing a tax assessment to the company. The bill also provides elaborate procedures for such an assessment; these include a notice from HMRC to the company stating the calculations involved, a right for the company to make representations, an obligation on HMRC to review the assessment (which enables negotiations), and rights of appeal against the assessment (although the assessed tax must first be paid).

Reasons for the Proposals

The main puzzle is why the U.K. is proposing to introduce these measures at a point when the OECD is barely halfway through the 30-month process of debating and formulating the reforms promised in the BEPS project.

The immediate reasons seem to be primarily political. The DPT bill was presented as part of the autumn statement package of fiscal projections and proposals for the budget to be introduced in the spring, a month before the next general election. The package from the right-wing Conservative chancellor of the coalition government projected a further drastic increase in public spending cuts, aiming to achieve a budget surplus by 2019-2020, which independent observers suggested would change the role of the state ''beyond recognition.'' In view especially of the impending elections in May 2015, this continuation of austerity policies needs some counterbalancing measures. This tax is one of the few measures listed in the statement under the heading of ''Fairness.'' Experience shows that Conservative politicians are more likely to introduce measures that appear tough on companies, as they have a greater need to soften their image than their Labour opponents, who are usually more concerned about alienating business. But it should be borne in mind that this chancellor also regularly stresses the need for the U.K.'s corporate taxes to be ''competitive'' and crafted legislation that essentially moved the U.K. to a territorial tax system on MNCs, as well as introducing the ''patent box.''

The proposals also could be seen as a stopgap. They provide a complex and legalistic way of doing what could have been done if the U.K. tax authorities had been willing to be as creative in interpreting tax rules to ensure that companies pay tax according to the economic substance of their activities as the companies' tax advisers have been in avoiding such taxes. As revealed in media reports, Google's U.K. affiliate, which claims to engage only in ''marketing,'' is closely involved in the sales of advertising only notionally ''booked'' to its Irish affiliate (considered by Ireland as resident in Bermuda). Thus, HMRC could have deemed the U.K. affiliate to constitute a PE of the Irish one, bringing its U.K. sales profits into U.K. tax. This approach has been used by tax authorities in other countries, such as India,[6] Italy, and Spain.[7] However, such an approach has been challenged in court, sometimes sucessfully, which was presumably why HMRC decided not to take the risk without the backing of new statutory provisions.

Third, the possibility that the U.K.'s general anti-abuse rule could have been extended to cover this situation must have been considered. However, the government's pledge that international arrangements would

[5]Randall Jackson, ''Starbucks Pays First U.K. Corporate Tax Since 2009,'' *Tax Notes Int'l*, July 1, 2013, p. 22.

[6]*Income Tax Officer v. Right Florist PVT Ltd.*, ITA 1336/Kol./2011: Income Tax Appellate Tribunal, Kolkata B Bench (2013).

[7]Adolfo Martín Jiménez, ''Preventing the Artificial Avoidance of PE Status,'' U.N. Tax Committee, Sept. 2014, section 5.3.2.

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not be covered by this already weak rule may have been too recent for that to have been a realistic option, although it may well be a part of the OECD's agenda for potential changes.

Implications for Tax Reforms

More interesting to consider is why the U.K. has introduced what amounts to a unilateral measure when major multilateral international tax reforms, through the OECD's BEPS project, are still being formulated. It seems reasonable to assume (to adopt the key phrase in the proposals) that the U.K. thinks that the BEPS project may fail to effectively deal with these problems, or that the likely measures may not suit the U.K. There is evidence to support both of these.

The OECD published proposals in November to deal with so-called abuse of PE rules. However, these would cover only a limited range of situations, where a foreign company supplying goods or services to a country also has an affiliate there that is involved in activities resulting in sales contracts. These might cover a case such as Google's in the U.K., in view of the ''marketing'' activities, but they would not extend to other Internet sales companies — for example, Amazon, which sells directly from its website but has affiliates in most countries engaged in after-sales activities such as customer support and order fulfillment. The concept of an ''avoided PE'' in the DPT bill is wider than the slight expansion envisaged in the OECD proposals. The requirement that there also be both ''mismatch'' arrangements and lack of economic substance narrows the scope, but the alternative tax avoidance purpose test means that it has a potentially much broader reach. However, it also creates uncertainty regarding operation of the tax.

The concept of ''mismatch'' arrangements goes beyond anything the OECD has yet proposed. The U.K. proposals build on the OECD's September recommendations on hybrid mismatch arrangements, but these are much more specific and the subject of consultations in the U.K. is based on another paper in the autumn statement package. The provisions also seem out of line with the EU rules in the recently revised parent-subsidiary directive, which aims to implement the OECD's hybrid mismatch proposals. This may be a likely basis for a legal challenge to the DPT, by a firm willing to risk public opprobrium by doing so.

The main thrust of the DPT, it seems, is a preemptive move by the U.K. to assert some jurisdiction over the large pools of earnings, estimated at some $2 trillion, retained ''offshore'' especially by U.S.-based MNCs.[8] Reforms to transfer pricing rules, especially on intangibles, envisaged in the BEPS action plan would reduce the size of these pools to some extent by attempting to reattribute earnings based on analysis of the ''functions, assets, and risks'' borne by the various affiliates of a MNC group. Nevertheless, there would remain large ''residual'' profits amassed in corporate cash-box holding companies.

A strengthening of rules on controlled foreign corporations, which may result from another of the BEPS action plan points, would reinforce the tax claims of the MNC's home jurisdiction while also acting as a disincentive to shifting profits from source countries. The DPT seems to be an assertion of a tax claim from the source country side, pre-empting residence country claims that might result from such stronger CFC rules. The intention may be not only to influence the BEPS process but also to pressure the U.S. Congress to reform the U.S. CFC rules in subpart F. This may explain why, despite the potentially broad scope of the tax, the estimate of revenues it might produce is relatively modest.

These interactions show that the next stage of the BEPS project, including implementation, will entail some competition between states over allocation of these revenues. Robert Stack, Treasury deputy assistant secretary (international tax affairs), suggested on September 23 that the OECD debates this year will focus on allocation of cash-box returns.[9] The U.K. has staked its claim through this tax, although the projection of comparatively modest sums to be raised by the DPT suggests that the government is willing to negotiate and compromise.

The U.K. is not alone. Australia is also contemplating a Google tax. Early in December China's Xinhua news agency quoted Zhang Zhiyong, recently promoted deputy director of the State Administration of Taxation, as saying that China will closely audit foreign-owned companies to guard against BEPS, though he stressed that it will coordinate with other countries.

Now the ball is in the OECD's court. If it can ensure a comprehensive and coherent package from the BEPS project, unilateral measures such as the DPT could be folded into the multilateral framework. Regrettably, it seems more likely that the outcome will be measures that are complex and leave considerable scope for interpretation and hence conflicts. The DPT proposal stakes out the U.K.'s claim in anticipation. ◆

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[8]Richard Phillips, Steve Wamhoff, and Dan Smith, ''Offshore Shell Games: The Use of Offshore Tax Havens by Fortune 500 Companies,'' PIRG/Citizens for Tax Justice (2014).

[9]Margaret Burow, David D. Stewart, and Kristen A. Parillo, ''Stack Provides Insights on BEPS Reports, Outlines Next Steps,'' *Tax Notes Int'l*, Sept. 29, 2014, p. 1087.

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