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by Tommaso Faccio and Jeffery M. Kadet

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FEATURED PERSPECTIVE

Will Bringing Sales Onshore in the U.K. Lead to Higher Taxes?

by Tommaso Faccio and Jeffery M. Kadet

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In this article, the authors discuss changes to the scope of the U.K. royalty withholding tax announced in the 2016 U.K. budget, which, along with the new diverted profits tax, could cause significant increases in U.K. tax paid by multinationals.

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On March 4, 2016, Facebook announced that its large U.K. customers would start receiving invoices from Facebook UK Ltd. instead of Facebook Ireland from the beginning of April.[1] Immediately following the announcement, a flurry of commentators predicted that Facebook would pay more in U.K. taxes because of this change. Given the recent disclosure that Facebook U.K. Ltd. paid just £4,327 in U.K. tax on turnover of almost £105 million in 2014, it seems the company's U.K. tax liability could only increase.[2]

On March 16, 2016, the U.K. government's 2016 budget announced planned rule changes concerning withholding tax on royalties. Not only will these changes affect royalties paid by normal taxpayers of corporation tax, but also those paid by taxpayers subject to the diverted profits tax (DPT).[3]

This article examines how the switch to local invoicing by companies such as Facebook UK Ltd., coupled with the new rules on royalty withholding tax, could affect the determination of taxable income for U.K. group members and the U.K. tax obligations of their respective groups. By way of illustration, we compare a group's U.K. and Irish tax liabilities under two scenarios: one in which sales continue to be made from Ireland and the Irish company is subject to the U.K. DPT, and the other in which sales are made from the U.K. The effects of the royalty withholding tax are also considered in the comparison.[4]

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[1]*See* Kamal Ahmed, ''Facebook to Pay Millions of Pounds More in U.K. Tax,'' BBC Online (Mar. 4, 2016).

[2]*See* ''Facebook U.K. Limited Annual Report and Financial Statements for the Year Ended December 31, 2014,'' *available at* https://beta.companieshouse.gov.uk/company/06331310/filing-history. Turnover is found in the profit-and-loss account on p. 6. *See* fn. 6 on p. 12 and fn. 11 on p. 15.

[3]*See* HM Revenue & Customs and HM Treasury, ''Overview of Tax Legislation and Rates'' (Mar. 16, 2016), at 90-93.

[4]This article does not consider any VAT issues that may arise in relation to the situations described in this article. The authors understand that since the Irish and U.K. suppliers and all customers relevant to the subject of this article are located in the European Union, there should be no significant differences in VAT treatment.

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Background

Public information on Facebook's structure is limited and contradictory.[5] It appears, however, that Facebook and other multinationals that make online sales of physical and digital products or provide Internet services (for example, advertising, cloud-based applications, sales of third-party physical and digital products, and so forth) from Irish-based companies have shielded significant income from the 12.5 percent Irish corporation tax. Multinationals have avoided corporation tax in this way through royalty structures and special rulings that subject only small distribution profits to Irish tax.[6]

It is unlikely that any similar special ruling could be obtained in the U.K. to provide a deemed royalty or other deductible charge so as to leave only distribution profits taxable there. Accordingly, multinationals that choose to invoice locally are likely to use a royalty structure to move income attributable to the value of underlying intangibles out of the U.K.

With the above in mind, this article is based on the following scenario. Company X, incorporated in the U.S., has transferred the economic rights to exploit its intellectual property outside North America to its non-U.S. subsidiary (CFC), which has no personnel or operations of its own[7] and is tax resident in a non-European country that imposes no corporation tax. At the same time, X and CFC entered into a cost contribution agreement (CCA).

As a result of the transfer and CCA, CFC will earn all future profits attributable to the IP from non-North American transactions regarding the manufacture and sale of physical products and the performance of services via an Internet platform. CFC makes payments to X under the CCA that represent CFC's share of ongoing intangible development costs incurred under the agreement.

CFC then licenses the IP, directly or indirectly, to an Irish group member (IrishCo). IrishCo, using its own personnel and facilities, services agreements with other group members, including X and a related U.K. company (UKCo). Using the IP rights granted to it under the license, IrishCo also manufactures and sells physical and digital products and provides various Internet services (such as advertising) to customers throughout its territory, which includes the United Kingdom. IrishCo recognizes all sales proceeds and service revenues.

IrishCo pays Irish corporation tax at 12.5 percent on its net income, after accounting for sales costs and expenses such as salaries, facility costs, server farm and broadband costs, service fees, and the royalty paid to CFC. The license has been structured to avoid withholding taxes, in Ireland or otherwise, on the royalty stream flowing directly or indirectly from IrishCo to CFC.

To address the need for vital marketing and customer support in the U.K., IrishCo has entered into a service agreement with UKCo, which has offices and personnel in the U.K. UKCo personnel conduct activities such as marketing, solicitation and negotiations with customers, product and service support, and so forth. The service agreement provides for a service fee to be calculated on a cost-plus basis.

X then decides to change its approach by having UKCo invoice U.K. customers and advertisers directly for all sales and services for which the UKCo personnel conduct negotiations and perform other significant services. Contracts for such sales and services will be concluded locally in the U.K. as a result.[8]

To implement the new approach, CFC will license to UKCo, directly or indirectly and on a nonexclusive

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[5]The authors have no personal knowledge of any information on Facebook Inc. and its subsidiaries beyond that in the public domain. Media reports provide conflicting information on Facebook's tax structure. On the one hand, many sources state that Facebook uses a common structure involving the Netherlands and Ireland to achieve deferral of U.S. tax and minimization of tax in the countries from which Facebook earns its advertising revenues. *See, e.g.*, Jesse Drucker, "Google 2.4 Percent Rate Shows How $60 Billion Is Lost to Tax Loopholes," Bloomberg (Oct. 21, 2010).

On the other hand, Bloomberg reported on Nov. 16, 2015, (Stephanie Bodoni, "Facebook, Google Quizzed by EU Lawmakers on Dutch Sandwich Deals") that Facebook has its European base in Ireland, a commercial office in the Netherlands, and a legal entity in Luxembourg but that no "Dutch sandwich" structure was involved and no preferential tax treatment was received in Luxembourg.

[6]Irish companies that earn revenue will pay actual royalties or will be allowed a deduction for deemed royalties to reflect the intangible value of the group's IP owned by a non-Irish resident group member. The distribution profits would be the Irish company's profits after deduction of these actual or deemed royalties.

[7]This structure is likely to reflect those created by many multinationals. Interestingly, the OECD's final base erosion and profit-shifting report on actions 8-10 provides that associated enterprises can only participate in a CCA if there is a reasonable expectation that it exercises control over the specific risks it assumes under the CCA and has the financial capacity to assume those risks. (See, in particular, para. 8.15 on p. 167 of the report.) CFCs with no personnel or operations of their own would presumably not meet this standard and so would not be considered to own the IP created under the CCA. This issue is not explored further in this article, since our primary focus is U.K. tax **(Footnote continued in next column.)** and the amount of any royalty paid does not depend on whether X or CFC is the economic owner of the IP.

[8]The movement of a significant portion of IrishCo's business from IrishCo to UKCo could prompt the Irish tax authorities to seek an exit charge of some kind, since it qualifies as a transfer of a portion of an existing business carrying rights, including goodwill. Further analysis of this issue is beyond the scope of this article.

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Table 1. Scenario One: Invoicing by IrishCo

(a)	IrishCo revenue for sales and services to U.K. customers involving U.K. solicitation, negotiations, and other support	1,000.00
(b)	IrishCo revenue for sales and services to U.K. customers involving little U.K. solicitation, negotiations, or other support	1,000.00
(c)	IrishCo cost of sales and all expenses (other than royalties) related to (a) (including service fee of 220.00 paid to UKCo)	300.00
(d)	IrishCo cost of sales and all expenses (other than royalties) related to (b) (including service fee of 55.00 paid to UKCo)	150.00
(e)	Royalties attributable to (a)	650.00
(f)	Royalties attributable to (b)	650.00
(g)	Taxable income on (a) revenues	50.00
(h)	Taxable income on (b) revenues	200.00
(i)	Irish taxation (at 12.5%) on (g)	6.25
(j)	Irish taxation (at 12.5%) on (h)	25.00

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basis, the rights to exploit the IP in the U.K. The licensing arrangements will be structured to avoid application of U.K. withholding tax, based on existing law before implementation of the changes proposed in the 2016 budget.

UKCo will recognize all sales proceeds and service revenues from the transactions and will pay U.K. corporation tax at 20 percent on its net income after accounting for sales costs and all other relevant charges. Once the changes to royalty withholding tax announced in the 2016 budget are implemented, a 20 percent U.K. withholding tax is assumed to apply to all royalty payments.

Aside from UKCo invoicing customers instead of IrishCo, the new approach requires no other operational changes. IrishCo assets used and personnel involved in U.K. sales and provisions of services will continue to be so used and involved. With UKCo now earning the revenue, IrishCo and UKCo will enter into an intercompany service agreement under which IrishCo provides services related to U.K. revenues and UKCo pays IrishCo a service fee.

Discussion

Invoicing by IrishCo

Table 1 contains an illustration of IrishCo's Irish corporation tax obligations before invoicing responsibilities were moved from Ireland to the U.K. Service fees between IrishCo and UKCo included a 10 percent cost-plus markup, and these amounts are assumed to exceed the minimum threshold for the DPT to apply.

Because IrishCo has no permanent establishment in the U.K., it would not be required to pay the 20 percent U.K. corporation tax on its taxable profits from sales and service revenues collected from U.K. customers and advertisers. The service fee paid by IrishCo to UKCo would be considered income of the latter that is subject to U.K. corporation tax.

Assume X had decided to continue its existing approach, under which IrishCo invoiced U.K. customers and advertisers directly. Assume that IrishCo provided timely notification to the U.K. tax authority, HM Revenue & Customs, that IrishCo is potentially subject to DPT. HMRC determines it reasonable to assume IrishCo has designed its U.K. activities to avoid creation of a U.K. PE. HMRC applies the DPT, sending IrishCo a preliminary notice first and, ultimately, a charging notice. If the charging notice is based only on the numbers provided for the (a) revenues in Table 1 (that is, only those involving U.K. solicitation, negotiations, and other support), then DPT can be calculated as shown in Table 2.

The 2016 budget included measures to expand the definition of royalties and the types of situations that will create U.K.-source royalties. One such amendment to the DPT rules would result in the amount of deductible royalties shown in Table 2 (that is, the 650 royalty amount enumerated at line (c) minus the 195 disallowed amount at line (d)) being treated as U.K.-sourced, and thus subject to the 20 percent U.K. withholding tax.[9] With this change taken into account, the total tax attributable to the Table 1 (a) revenue is shown in Table 3.

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[9] *Supra* note 3, at 91:

Legislation will also be introduced at a later stage of the Finance Bill 2016 process to add a new provision to the

(Footnote continued on next page.)

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Table 2. DPT Payable by IrishCo

(a)	IrishCo revenue for sales and services to U.K. customers involving U.K. solicitation, negotiations, and other support	1,000.00
(b)	IrishCo cost of sales and all expenses (other than royalties) related to (a)	300.00
(c)	Royalties attributable to (a)	650.00
(d)	30% disallowance under inflated expense condition	(195.00)
(e)	Taxable income on (a) revenues	245.00
(f)	U.K. DPT at 25%	61.25
(g)	Credit for Irish taxation	(6.25)
(h)	U.K. DPT payable	55.00

The figures arrived at in this example could vary in practice for several reasons. First, the various expense amounts applicable to the (a) revenues (that is, those applicable to sales and services rendered to U.K. customers involving U.K. solicitation, negotiations, and other support) are, to some extent, made on various bases with which HMRC might disagree.

Second, although the royalty deduction has been adjusted to reflect the 30 percent disallowed amount under the inflated expense condition, HMRC could change the amount of the nondeductible portion. The higher 25 percent DPT rate will apply to the nondeductible portion instead of the lower, 20 percent royalty withholding tax rate.

Third, taxpayers might disagree with HMRC over whether some of the (b) revenues in Table 1 (that is, those applicable to sales and services to U.K. customers that involve little U.K. solicitation, negotiations, and other support) should have been classified as (a) revenues instead.

Overall, there is a reasonable level of uncertainty over what the ultimate DPT tax obligation will be. Inherent uncertainties also exist within the DPT process, which relies on taxpayers notifying HMRC, which then assesses the amount of DPT payable. The assessment often implicates revenue and expenses of group members that cannot easily be subjected to direct HMRC scrutiny.

Nevertheless, accounting standards under both U.S. generally accepted accounting principles and international financial reporting standards either require,[10] or are expected to soon start requiring,[11] that financial statement treatment of situations involving tax uncertainty be reported on the assumption that the appropriate tax authorities have full knowledge of all relevant information. This article has been written with this reporting requirement in mind, since the facts surrounding the revenue earned from the U.K. by X and its subsidiaries correspond to the legislated targets of the DPT and changes to royalty withholding taxes announced in the 2016 budget.

Invoicing by UKCo

Assume that under the second scenario, X shifts all Table 1 (a) revenue from IrishCo to UKCo by having UKCo invoice customers and advertisers directly. UKCo will no longer receive the service fees attributable to the (a) revenue (although it would still receive the service fees attributable to the Table 1 (b) revenue). UKCo and IrishCo's profits, corporation tax, and obligations for royalty withholding tax in respect of the Table 1 (a) revenue will be calculated as shown in Table 4.

Intercompany pricing concerns will persist over the amount of service fees payable between IrishCo and UKCo. When UKCo earns all (a) revenues, however, it is far less likely that any of IrishCo's (b) revenues will be treated as related to an avoided PE under the DPT rules.[12]

Tax Acts providing that royalties connected with a permanent establishment that a non-UK resident person has in the UK will be considered to come from a source in the UK. Consequential changes will also be made to the Diverted Profits Tax in Part 3 of the Finance Act 2015 to ensure that no advantages accrue where royalties are connected with avoided permanent establishments as compared to actual permanent establishments.

[10]*See* Financial Accounting Standards Board, "FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes — An Interpretation of FASB Statement No. 109," *available at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1175801627860&acceptedDisclaimer=true.

[11]*See* IASB/IFRS, "Draft IFRIC Interpretation DI/2015/1 — Uncertainty Over Income Tax Treatments" (Oct. 2015).

[12]With low levels of solicitation, negotiation, and other support rendered by UKCo, the X group is likely to be sufficiently satisfied that DPT should not apply so that it might not provide

(Footnote continued on next page.)

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Table 3. DPT Payable by IrishCo Plus Royalty Withholding Tax Payable

(i)	U.K. DPT payable (h)	55.00
(j)	Royalty withholding tax (20% of 455 net royalties)	91.00
(k)	UKCo corporation tax on services provided to IrishCo in respect of (a) revenues (20% of (220 - 200))	4.00
(l)	IrishCo tax on net income from (a) revenues	6.25
(m)	Total taxation attributable to (a) revenues	156.25

Table 4. Scenario Two: Invoicing by UKCo

(a)	UKCo revenue for sales and services to U.K. customers involving U.K. solicitation, negotiations, and other support	1,000.00
(b)	UKCo cost of sales and all expenses (other than royalties) related to (a) (including service fee of 88.00 paid to IrishCo)	288.00
(c)	Royalties attributable to (a)	650.00
(d)	Taxable income	62.00
(e)	U.K. corporation tax at 20%	12.40
(f)	Royalty withholding tax at 20% of (c)	130.00
(g)	Total U.K. taxes	142.40
(h)	Additional Irish tax on 88 paid to IrishCo (12.5% of (88 - 80))	1.00
(i)	Total taxes	143.40

Accordingly, the tax payable in this scenario is lower than that payable when DPT applies, and it comes with a considerably higher level of certainty in relation to the group's tax obligations. (Since the 20 percent rate applies to both the royalty withholding tax and corporation tax, normally significant transfer pricing concerns over the level of royalties for hard-to-value intangibles will have no practical relevance for U.K. tax purposes.)

Comparison Summary

As will be seen in Table 5, the combination of DPT and the extension of royalty withholding tax to avoidance arrangements has a major impact. Further, total U.K. and Irish tax costs attributable to (a) revenues fall as a result of X's decision to shift invoicing responsibilities from IrishCo to UKCo.

Much of the beneficial difference owes to the avoidance of the higher, 25 percent rate DPT, as opposed to the 20 percent corporation tax. This difference will only increase if plans to reduce the corporation tax rate to 17 percent by 2020 are implemented.[13]

The other significant and particularly beneficial differences from UKCo invoicing are the increased certainty in the level of tax payable on (a) revenues and the greatly reduced risk that any portion of the (b) revenues will be subject to DPT and royalty withholding.

Home Country Tax/Royalty Withholding

In this example, X is a U.S. corporation that has set up a profit-shifting structure to prevent recognition of the group's income from intangibles being subjected to

notice of the potential application of DPT to HMRC. *See* "HMRC Diverted Profits Tax Guidance" (Nov. 30, 2015), at 87-88:

> [I]t is open for a company to reasonably assume that no charge to DPT will arise. This may be so even though the conditions for a charge, such as the tax mismatch and insufficient substance conditions, appear to be met and the transfer pricing or PE attribution analysis has not been examined by HMRC.

[13]While the corporation tax rate is expected to be lowered, the withholding tax on royalties is expected to stay at 20 percent. Once these two rates diverge, the amount of royalties could create a significant difference in tax payable.

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the 35 percent U.S. federal tax and applicable state and local taxes. This income, of course, includes the (a) revenues.

The 20 percent U.K. royalty withholding tax clearly comprises most of the tax paid in connection with the (a) revenues. If a U.S. corporation with similar operations to X found it beneficial, it could unwind its profit-shifting structure so that a U.S. group member earns the royalties. By doing so, the royalties would be subject to U.S. taxation and thus would fall outside the scope of the new tax avoidance rule announced in the 2016 U.K. budget, which imposes the 20 percent royalty withholding tax.

Since the U.S. group member would qualify for the benefits of the U.K.-U.S. tax treaty, the royalty withholding would be eliminated under article 12 of the treaty. This would appropriately leave only the distribution profits being taxed in the U.K.[14]

The level of the royalty will be determined subject to transfer pricing rules. The profit-shifting structure illustrated in this article includes CFC as the licensor and UKCo as the licensee. Under such an arrangement, no treaty-based dispute resolution mechanism will be available to determine the royalty payable by the licensee to the licensor and to prevent potential double taxation. Mechanisms that might technically be available due to the involvement of an intermediary company as part of a back-to-back arrangement through, for instance, the Netherlands, are unlikely to provide serious competent authority support.

By contrast, when the profit-shifting structure is unwound so that the licensor is a U.S. resident under the U.K.-U.S. tax treaty, a clear mechanism is available with two real competent authorities available to resolve any disputes over the amount of the royalty. Once the royalty amount is determined, the remaining profits in UKCo will be the appropriate distribution profit. There will be no risk of double taxation.

Facebook is not the only multinational entity to consider recognizing revenues within local subsidiaries. Amazon has reportedly established, or is planning to establish, taxable branches in France, Germany, Italy, Spain, and the U.K.[15] Not only are other multinationals likely to follow Amazon and Facebook's lead, but other countries may well follow the U.K.'s lead in establishing DPTs and expanding royalty withholding taxes to avoidance structures.

Many countries are also likely to expand their definitions of PEs over the next few years to include digital presences. Whether this occurs through the OECD continuation of the base erosion and profit-shifting project or individual country action,[16] when combined with proliferation of the new approach to royalty withholding taxes, it will again broaden the application of high withholding taxes. Expanded definitions of PEs will put further pressure on multinationals to reconsider their continued use of profit-shifting structures.

Many such structures, like those used by X in this illustration, come with a high likelihood of being subject to direct U.S. taxation.[17] For multinationals facing significant royalty withholding taxes in a growing number of countries, it is another compelling reason to consider unwinding profit-shifting structures.

Two foreign tax credit issues should be noted. First, any U.S.-based multinationals whose foreign subsidiaries are subjected to DPT-type taxation or royalty withholding will be unable to obtain FTCs for either until the subsidiaries repatriate their earnings through dividends.[18] Second, when U.S. tax is directly imposed on the foreign group member's effectively connected income, the credibility of the foreign taxes may be severely limited by the FTC limitation formula. This result will arise when much of the income on which the foreign taxes were paid is considered U.S.-source income under domestic income sourcing rules.

Multinationals, whether based in the U.S. or in other countries, may have other reasons to consider unwinding profit-shifting structures to take advantage of tax treaties that enable avoidance of royalty withholding taxes and DPT through a new structure that falls outside its scope (for example, through earning U.K. revenues within a U.K. company). For example,

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[14]Unwinding the profit-shifting structure would, of course, mean that income earned outside the U.S. would be subject to the standard 35 percent U.S. corporation tax. This result might encourage X to continue with its current structure, despite the additional U.K. taxation.

[15]*See* RFI, "Amazon to Pay Taxes in France, Other EU Countries After LuxLeaks Scandal," RFI (May 26, 2015).

[16]*See* OECD, "Addressing the Tax Challenges of the Digital Economy, Action 1 — 2015 Final Report," at 148. While the OECD decided not to recommend any of several options considered, the report encourages countries to implement such options on their own, stating:

> Countries could . . . introduce any of the options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties.

[17]*See* Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets," *Tax Notes*, July 13, 2015, p. 193; Thomas J. Kelley, David L. Koontz, and Kadet, "Profit Shifting: Effectively Connected Income and Financial Statement Risks," 221(2) *Journal of Accountancy* 48 (Feb. 2016); and Kadet and Koontz, "Profit-Shifting Structures and Unexpected Partnership Status," *Tax Notes*, Apr. 18, 2016, p. 335.

[18]The U.S. subpart F controlled foreign corporation rules are not considered here, which will typically be the case since most profit-shifting structures have been designed to sidestep these rules. The question whether the DPT is a credible tax under the U.S. foreign tax credit rules is also not considered. *See* Philip Wagman, "The U.K. Diverted Profits Tax: Selected U.S. Tax Considerations," *Tax Notes*, June 22, 2015, p. 1413. *See also* New York State Bar Association letter of Nov. 24, 2015, to the U.S. Treasury and the IRS.

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Table 5. Comparison Summary

Taxation of (a) Revenues	Total U.K. and Irish Tax Costs
Pre-DPT and pre-2016 budget with invoicing by IrishCo (6.25 Irish tax plus 4 U.K. tax)	10.25
With DPT and 2016 budget and invoicing by IrishCo	156.25
With DPT and 2016 budget and invoicing by UKCo	143.40

multinationals experiencing continuing tax losses or credits in their home country so that they pay only low amounts of tax there may be considerably better off obtaining treaty exemptions or reductions in withholding taxes available under the treaty network that their home country maintains.

Although the above discussion has predominantly focused on U.S.-based multinationals, many of the issues also apply to multinationals based in other countries that have instituted profit-shifting structures.

Conclusion

The initiation of DPT and the changes to royalty withholding announced in the 2016 U.K. budget have a major impact on the economics of profit-shifting structures that require on-the-ground sales, marketing, and other support activities in the U.K. The U.K.'s actions will be closely examined and may well be followed by numerous other countries feeling the effects of aggressive profit-shifting structures.

If U.K.-style provisions are adopted in many other countries, multinationals worldwide should rethink the economics and risks of their profit-shifting structures, given the significant increase in local taxation that will result. Multinationals should consider unwinding their profit-shifting structures when the benefits no longer justify the risks or administrative costs and inconveniences. ◆

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