Does the UK Diverted Profits Tax help or hurt BEPS?

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Jonathan Schwarz (Temple Tax Chambers; King's College London)

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The OECD Joint Working Group on Business Restructurings is, in many respects, the precursor to the OECD BEPS project. Unresolved Business Restructuring issues, particularly in relation to permanent establishments, have appeared on the BEPS agenda. One question asked by the Joint Working Group was: Can an agency PE exist if the arrangements entered into did not make commercial sense and were primarily structured to avoid the creation of a PE? The question reappeared in the 2010 OECD consultation on PE but was never answered.

The question, properly put, would simply have been whether certain arrangements might, in appropriate circumstances, constitute an abuse of the PE definition, such that a court might not give effect to the arrangements, and find that a PE in fact existed. BEPS Action 7 frames a question in these terms but does not attempt an answer. Instead, an amended definition of PE is proposed, suggesting that the proper answer would normally be to uphold the existence of the PE.

Tax on PE Avoidance

The proposed UK "diverted profits tax" announced in the Autumn Statement on 10 December 2014 reveals that the awkwardly expressed Business Restructuring question likely originated in the UK. This proposed tax charge is primarily intended to apply to arrangements designed to ensure that a foreign company that supplies goods or services to customers in the United Kingdom does not carry on a trade in the UK through a PE in the UK.

Mismatch Condition

In addition, the diverted profits tax requires that a "mismatch condition" be met. This is met where:

- Firstly, in connection with the supplies of goods or services, a provision is made or imposed by means of a transaction or series of transactions, as between the foreign company and another person associated for transfer pricing purposes. These transactions must result in a reduction of non-UK tax liability for the foreign company which exceeds the tax liability of the other person from the transaction. There is no mismatch where the tax of the other person is at least 80% of the tax of the foreign company;
- Secondly, in addition, where the tax benefits outweigh other financial benefits of the transactions in circumstances detailed in the legislation, then the "insufficient economic substance condition" is met to fulfil the mismatch condition.

The new tax may apply where there is no mismatch if the main purpose or one of the main purposes of arrangements in connection with the supply of goods or services is to avoid a charge to corporation tax.

"Recharacterisation Charge"

Specific authority is given to recharacterise transactions in calculating the profit of an avoided PE for purposes of the tax. This permits the substation of a provision which it is "just and reasonable" to assume would have been made or imposed if the avoided PE had been a UK PE through which the foreign company carried on the trade and which would not itself have resulted in a tax mismatch.

The primary charge is plainly directed at US based multinationals such as Amazon, Apple and Google whose sales to UK customers are by companies based in other EU member states such as Ireland and Luxembourg who have no UK PE, and where profits of those companies are reduced by payments to low-tax jurisdictions such as Bermuda.

Tax on "Insufficient Economic Substance"

A separate charge to diverted profits tax applies in relation to a UK resident company where a tax mismatch arises by means of a related party transaction or series of transactions involving a resident or non-resident where the insufficient economic substance condition is met. Thus UK companies, for example, paying royalties that end up in low tax jurisdictions may be subject to the tax. If the recipient of the payment is owned by a UK company, the tax may apply even if the UK CFC charge is excluded (where the local tax is 75% of the UK rate).

Treaty Avoidance

While the tax is drafted around avoidance of PE's as defined in UK domestic law, the 27 page draft legislation and 50 page draft guidance published by HM Revenue & Customs was silent on the relationship between the tax and UK treaties. If the tax is subject to UK treaties, it may have little practical effect. HMRC have, however publicly asserted arguments in support of the tax canvassed in BEPS Action 6 on the relationship between domestic anti-abuse rules and treaties. HMRC primarily rely on arguments based on *Bricom v IRC* [1997] BTC 471; [1996] STC 228 that the tax is not corporation tax and, thus, outside the scope of domestic law that gives effect to treaties to prevent assertion of treaty benefits (See *Schwarz on Tax Treaties* Chapter 2 para 10-250 for details).

Impact on Cross-border Trade

Multinational groups that supply goods or services to UK customers will need to add the impact of this new tax to their transfer pricing and PE analysis. The UK tax sensitivity of their arrangements is heightened by the fact that the tax may apply whether or not the structure is also designed to secure any commercial or other objective.

A company potentially within the tax must notify HMRC within 3 months of the end of an accounting period. The application of the tax may however be selective in practice. Unlike other taxes that are of general application and self-assessed by taxpayers, the diverted profits tax is applied by administrative decision of HMRC officers. Current law (see *R v IRC; ex parte National Federation of Self-employed and Small Business Ltd* [1982] AC 617) normally gives HMRC a wide margin of discretion in the application of such taxes. The tax is stated to come into effect from 1 April 2015 and contains no grandfathering for existing structures.

The diverted profits tax is intended to be punitive. It will be levied at 25% of diverted profit compared to 20% corporation tax on normal taxable profit. The Government expects to raise £25 million in 2015-15, rising to £355 million in 2019-20. HMRC state that the measure is not expected to have any significant economic impacts.

BEPS Work Pre-empted

The Autumn Statement 2014, coming before what will be a very keenly contested general election, was a highly political statement. The diverted profits tax, even by its title, aims to make good on political promises to extract more tax from companies like Google. It is however unilateral and pre-empts any international consensus that the OECD and G20 may seek on a new approach to a balanced allocation of taxing jurisdiction that appropriate for the 21st Century. If other countries follow this approach, the international tax system is likely to be more fragmented, unpredictable and conflict ridden.

The diverted profits tax side-steps the central responsibilities of the BEPS: it make no contribution to whether existing definitions of PE, designed in a different world of international trade, are still suitable or whether existing law on the location of trade or business still holds good. Similarly, it makes no contribution to resolution of the balanced allocation of taxing powers for the digital economy.