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U.K.'s "Diverted Profits Tax": A Regime Much, Much Broader Than its True Target?

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The introduction of a new Diverted Profits Tax was announced in the U.K. 2014 Autumn Statement. The scope of the new proposals and their potential impact on benign corporate structures could greatly increase the "compliance" cost of doing business in or with the U.K.

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I. Introduction

In early December 2014, the U.K. Government announced plans to introduce a new tax, alongside the ordinary charge to corporation tax, designed to deal with cases in which the "right" amount of U.K. corporation tax was not being paid by multinational groups. Swiftly dubbed the "Google Tax" by the media, it might be assumed that the new "diverted profits tax" ("DPT") regime has a narrow scope and limited application away from the "new media" sector. This is not the case.

The following considers the potential scope of DPT, putting aside the important (prior) question as to whether the U.K. should be taking such unilateral steps at this stage in advance of more concrete proposals from the OECD's BEPS programme and ignoring, for now, whether the new regime would be compliant with the U.K.'s European Union obligations.

II. New Regime

The new DPT will be levied at 25% in two instances, where:

(i) A non-U.K. company supplies goods or services to U.K. customers and there is a U.K. person which carries on an activity in the U.K. in connection with those supplies without there being a permanent establishment in the U.K. This is the "PE avoidance" limb designed to apply, e.g. to non-U.K. companies providing digital services into the U.K. from abroad; and

(ii) A U.K. taxable person enters into arrangements without economic substance with a non-U.K. related entity. This is the "U.K. profits reduction" limb, designed to apply, e.g. to U.K. trading entities paying away a large proportion of turnover to non-U.K. related entities for intra-group supplies of goods or services.

The first limb applies only if both the U.K. and non-U.K. companies are not small or medium-sized entities ("SMEs") and if total sales to U.K. customers in a

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given accounting period exceed 10 million pounds. The second limb applies only if the group to which the U.K. and non-U.K. entities belong is not an SME.

So far, so good. However, if one looks a little deeper, the new regimes apply more broadly.

Looking at the PE avoidance limb, this will apply to a non-U.K. company where a person carries on an "activity" in the U.K. "in connection with" supplies of goods or services to U.K. customers, it is "reasonable to assume" that the structure is designed to ensure that there is no PE in the U.K. and it is "reasonable to assume" that either or both of the "tax avoidance" or "mismatch" conditions are met. Those conditions require that there be is a main purpose of avoiding a charge to U.K. corporation tax; or that there are commercial relationships between the foreign company and another related entity that give rise to an "effective tax mismatch" and lack "economic substance".

There is an effective tax mismatch if:

- The income of one person is reduced or its tax deductible expenses are increased and the resulting reduction in the tax liability of that person is greater than the increase in the tax liability of the other party to the arrangements; and
- The increased tax bill of the second party is not at least 80% of the reduction in the tax bill of the first party. Relationships will lack economic substance if the financial benefit of the tax reduction is greater than any other financial benefit referable to the relevant transactions or if the contribution of "economic value" by a person is less than the value of the financial benefit of the tax reduction and, in each case, it is "reasonable to assume" that the arrangements were designed to secure the tax reduction.

There is, as yet, no definition of what constitutes an "activity" in the U.K., nor of when the relevant "connection" with U.K. supplies will be present, nor of when it would be objectively "reasonable to assume" that arrangements were designed to meet certain objectives. These matters are to be left, it would appear, to the courts to work out on a case-by-case basis. More fundamentally, the effective tax mismatch rules seem simply to ask whether the tax bill of one entity is reduced and the tax bill of another entity is not increased without looking at the overall tax impact of the arrangements for the wider group on a global basis.

Thus, if a U.K. company has expenses that reduce its tax liability and those sums are paid to a U.S. entity that is not itself a taxpayer (e.g. as a result of a check-the-box election) but the sums are taxable in the hands of another person (whether in the U.S. or otherwise), is that an effective tax mismatch? Although one might think not, the rules as drafted would seem to conclude that it is.

Similarly, the economic substance test asks whether the financial benefit of a tax reduction is greater than any other financial benefit without providing any guidance as to how those benefits should be valued and without identifying how taxpayers are to go about identifying "economic value" to be measured against the benefit of a tax reduction.

The U.K. profits reduction limb applies where there is an arrangement between a U.K. resident and another related person which gives rise to an effective tax mismatch in circumstances where the insufficient economic substance condition is met. As such, this limb also suffers from the same uncertainties of scope as the PE avoidance limb.

The new rules are so broadly drafted as to potentially to apply to perfectly benign corporate structures which may have been in place for many years and have, hitherto, been accepted by HMRC as compliant with U.K. tax rules and, in particular, with the requirements of the transfer pricing regime in the U.K. That such arrangements are, apparently, at arm's length is no basis on which to escape the new DPT regime.

Consequently, it would seem that all multinationals doing business in or with the U.K. will need to reexamine every commercial relationship to see whether there is activity in the U.K. connected with U.K. supplies of goods or services, disparities between the tax liabilities of any U.K. entity and any other entity with which it has a commercial relationship, and/or financial benefits from U.K. tax bills lower than they might otherwise have been (in some comparator world), which benefits exceed any other (non-tax) benefits from the relationships concerned. This represents a potentially mammoth task for larger corporate groups and will greatly increase the "compliance" cost of doing business in or with the U.K.

III. Pay Now, Argue Later

Another new, and objectionable, feature of the DPT regime is that the HMRC will be able to determine that DPT should apply by issuing a preliminary notice to a taxpayer. There is then to be a 30-day period for representations, after which the tax authority may issue a charging notice, that notice being permitted to calculate the tax due by disallowing 30% of expenses that are thought (by HMRC) to be too high. The sum determined by such a process to be due must then be paid within a further 30 days. Thereafter there is to be a 12-month period in which the charge can be reviewed and adjusted based on evidence provided by the taxpayer. Only at the end of that review period, i.e. a further 12 months on from the initial charge, is the taxpayer permitted to appeal to challenge the DPT charge itself.

The effect of such a timetable is that anyone facing a preliminary notice will know that the tax is immediately due and any appeal cannot be lodged until another year has passed, during which time the taxpayer can attempt to reduce the sum in issue by providing further evidence to HMRC but cannot, as yet, challenge the demand before an independent tribunal. In effect, the U.K. Government will have the use of the sums demanded for a year before the appeal is made and then during the entire appeal process.

IV. Other Matters

It is also quite unclear, at present, how DPT will fit into the U.K.'s double tax relief regime. In particular, is DPT a tax that is to be covered by the U.K.'s network of treaties? Will DPT be a creditable tax in other jurisdictions, e.g. the U.S.? Exactly what compliance burdens will be placed on overseas companies that are, or may be, subject to the new tax? With a proposed start date of April 1, 2015, these are all questions which will require a swift and satisfactory answer.

V. Conclusion

It remains to be seen how and when the new rules will be introduced and, in particular, whether the drafting can be tightened up to deal with some of the evident difficulties. What seems to be clear, however, is that the political decision to impose such a DPT has been taken, the basic thrust of the regime is unlikely to be altered and the draftsman is going to err on the side of caution by expressing the charge to tax as broad as is perceived to be necessary. One will be left, as is increasingly common, to find a workable regime through trial and error and with the benefit of HMRC guidance. Given the importance of corporate tax charges to businesses operating in multiple jurisdictions, this is an unsatisfactory state of affairs.

Jonathan Peacock QC is a tax barrister based in London with a broad practice in corporate tax and VAT, especially relating to international tax and cross-border matters. He appears regularly in the U.K. courts and the CJEU and frequently advises on complex matters in the finance, media and energy sectors. He has acted in tax-based arbitrations and mediations and appeared as an expert witness in foreign courts.