THE PROPOSED UNITED KINGDOM "DIVERTED PROFITS TAX"

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INTRODUCTION

The United Kingdom proposes to introduce, on profits arising as of April 1, 2015, a "Diverted Profits Tax." This is intended to override the normal international tax arrangements when H.M.R.C. (the U.K. tax authority) does not like the outcome. Domestic laws, O.E.C.D. practice, and a network of Double Tax Agreements provide a definition of "Permanent Establishment" defining what income is or is not taxable within the country of operation. Similarly, "Transfer Pricing" rules should enable the tax authorities to ensure that the price used for transactions between related entities is appropriate for calculating proper division of taxable revenue between the countries concerned. While many believe that these are not working as well as they should, the problems need a more subtle and sophisticated solution rather than a blunderbuss approach.

The "Diverted Profits Tax," at a rate of 25% (mildly penal, compared with the Corporation Tax rate of 21%), is to be imposed if H.M.R.C. does not like the answer produced by these well-established procedures and succeeds in claiming, under this new law, that profits have, nevertheless, been "diverted." The draft legislation sets out very detailed rules. These are available on the H.M.R.C. website, but those who follow matters very closely would be well-advised to continue to examine the extensive comments that are being made. The draft legislation gets very close to giving H.M.R.C. the power to determine unilaterally the level of taxable income. "Tax by administrative discretion" is a policy normally associated with authoritarian or left-wing governments. The United Kingdom may well, post-election, have a left-wing government who will be delighted to be presented with what, to them, is a very attractive measure.

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APPROPRIATE STRATEGIES FOR AFFECTED BUSINESSES

What do those affected by the draft legislation and their advisers need to do or know? The provisions will not apply to S.M.E.'s, *i.e.*, groups with less than £10 million of annual sales within the U.K. Others will need to consider their position very carefully and make contingency plans on the assumption that the provisions will be enacted, although perhaps in a substantially amended form. H.M.R.C. forecasts that the measure will eventually bring in £350 million per annum, but goes on to say that it "is not expected to have a significant economic impact." American readers in particular will be well aware that there is a huge gap between the initially-forecast yield of a tax avoidance measure and the outcome. Hastily proposed and badly designed tax legislation is often more successful at creating economic damage than producing revenue or desirable changes in activities.

There may well be technical loopholes in the final form of the legislation, but no sensible commentator would draw attention to these before the Parliamentary process is complete. The legislation will be included in the 2015 Finance Bill and may or may not take into account the invited public comments. In a normal year, this legislation would then go through several Parliamentary stages before being signed into law ("the Royal Assent") in late July. This year, though, the General Election on May 7 will intervene. Normal practice in these circumstances is to introduce a brief bill quickly to ensure that taxes can continue to be collected and include certain announced provisions. A more detailed bill is then brought forward by the incoming government. There is a danger, in this case, that controversial measures may be rushed through without Parliamentary scrutiny, resulting in years of challenges before the Courts – in particular regarding the breach of Double Tax Agreements. (The European Court of Justice may, uncharacteristically, actually be helpful.)

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International companies with significant operations (£10 million plus) in the U.K. will, as usual, calculate their strategies and their options in after-tax terms, and where, as here, the law is not clear and leaves too much to administrative discretion, they will be advised to make commercial decisions on "worst-case" assumptions. This, though, still leaves the option to pursue all available remedies in the Courts to secure a better answer. As an adviser on tax policy, I have often pointed out (notably, on this topic in Russia, where the excellent Tax Minister and the Kremlin had predictably different views) that lack of certainty can result in the country receiving both lower investment and lower tax revenue than if it had imposed more responsible policies.

Affected companies may decide, commercially, to retain much of their U.K. activities as at present. If they have been pursuing an aggressive tax planning strategy, they may simply decide that the game may be over. Many others, who have been taking normal, unaggressive advice on optimizing after-tax profits taking account of international tax provisions, may find they have to watch their position. They may decide to err on the side of making sure that their tax charge is high enough to satisfy the U.K. revenue, paying their 21% tax and avoiding the risk, hassle, and expense of precipitating an investigation into alleged "Diverted Profits." They must then remember that any change in strategy resulting in more tax being paid to the U.K. will deprive another jurisdiction of revenue, and these might well (if they are not blatant tax havens) try to insist on the proper interpretation of agreements. Many years ago, transfer pricing rules were only invoked against blatant transfers of profits to "tax havens," but when the U.S. began using them aggressively to get a larger share of the total revenue from transactions with other high-tax countries, the latter were forced to retaliate.

Other strategies could include making significant changes to avoid the problem. It is too early to know the exact rules, but the principles are straightforward enough. The simplest is to stop trading into the U.K. or, in the case of small companies, make sure that sales are below the £10 million limit. Where appropriate, they may simply cease to have any relevant activities within the U.K. and treat it simply as an export market. There are some interesting compromises that will surely be pursued, but detailed advice will be needed on where the line is drawn when the legislation is in its final form.

What preparatory operations, if any, could be carried on within the United Kingdom? The obvious ruse of having U.K.-based employees soliciting orders where they are

then referred to Dublin or wherever for the final contract to be drafted surely won't work. What if the people concerned are moved to Dublin (or replaced by new people employed there) who solicit their orders by telephone or email? If they, personally, are or become nonresident in the U.K., to what extent, if at all, can they visit customers in the U.K. during short visits?

Another variation, which might help to enable profits to arise in a moderately low tax country in a Treaty relationship with the U.K., would substantially be to increase the activities carried on in that country to give substance to the activities and to justify a reasonable proportion of the profits arising there under Treaty rules and procedures. Another, which I have used in the past, would be to hive off the U.K. sales and service operations to an independent company, which could employ and possibly be owned by the existing staff. Great care would have to be taken to make sure this is genuinely independent.

THE POLITICS

H.M.R.C. is probably hoping that, faced with the hassle and penalties, companies will simply cease to attempt to optimize their tax liabilities and will be terrorized into paying more tax than they need legally to do. Unfortunately, though, they may react by concentrating their business efforts elsewhere. Remember that Starbucks was criticized for having a trivial corporation tax liability. However, it would have been collecting and handing over to H.M.R.C. Value Added Tax on this turnover, and Social Security and Income Tax on its employees. Published statistics of the breakdown of tax revenue indicates that the first three taxes bring in over ten times as much revenue as corporation tax.

The Diverted Profits Tax has all the hallmarks of over-hasty legislation rushed into law in response to a press-oriented public campaign. A reader need not be British to know that, in the run-up to an election campaign, politicians are far more interested in proposing populist measures than financially sensible ones.

As with the U.S. approach to "Inversions," this solution is addressing the wrong question. The old rules regarding C.F.C.'s and transfer pricing, which used to work perfectly well, now seem to be less effective. One reason is the sheer complexity of legislation that has grown out of ill-conceived political reactions to perceived problems. There are also some real issues and abuse, notably in electronic trading. These need to be addressed, and Double Tax Agreement provisions need to be updated for a range of reasons. However, this requires an international solution, on which the O.E.C.D., through its B.E.P.S. initiative, is working. This may or may not produce the right answer - but why not wait and see?

Political initiatives these days, including this one, often represent an overreaction to an understandable, but not well advised, press campaign against particular abuses. Oddly, many of the companies that are accused of diverting profits from the U.K. to associated, lower-tax companies are American-owned and are likely advised by highly paid professionals who know how to navigate around complex anti-abuse rules, as well as U.S. C.F.C. legislation.

BRIEF DETAILS

Last month in *Insights*, I described briefly the key issues in the draft legislation. The new tax is to apply in two broad circumstances. One involves avoiding a taxable presence in the form of a Permanent Establishment in the U.K. of which H.M.R.C. disapproves and creating a tax advantage by means of transactions or entities which lack economic substance.

- The first case arises if there are activities within the U.K. in connection with the supply of goods and services to customers there by a foreign company in such a way that there is no Permanent Establishment under established rules. If it is then "reasonable to assume" (by H.M.R.C.) that these activities are designed to ensure that the company is not carrying on a taxable trade, it will be attacked.
- The second case may involve financial arrangements or non-financial arrangements leading to a tax mismatch. Both are liable to be attacked. There is an effective tax mismatch if there is an increase of expenses by, or a reduction in the income of, the U.K. party (with a corresponding change in the foreign party and the tax charge on the foreign party is less than 80% of the U.K. charge). There are full details available on the H.M.R.C. website.

SOME GENERAL THOUGHTS ON ANTI-AVOIDANCE POLICY

Several years ago, a badly directed campaign began in the British Press on tax avoidance policy. Many thought the press campaign to be an overreaction, but since then, precisely these types of overreaction measures have been overwhelming us everywhere. We are getting dangerously close to the type of anti-avoidance provision that effectively means that the tax authorities can re-write a transaction to get the best result for themselves. This produces uncertainty. Where there is uncertainty, a properly advised investor, particularly a foreign investor, will work out the tax consequences and make their decision whether or not to go ahead on a worst-case assumption. If, however, they do go ahead, they will then do their best to secure the better solution. As mentioned above, the net result of the Diverted Profits Tax will be well received headlines in the press followed by less investment and less revenue for the U.K. economy.

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