U.K. IMPLEMENTS 25% "GOOGLE TAX" ON DIVERTED PROFITS

Authors
Christine Long
feat. John Chown

Tags
Diverted Profits Tax
Economic Substance
Google Tax
Multinational Companies
Permanent Establishment

John Chown is a Senior Partner of Chown Dewhurst L.L.P. in London He is an economist with a focus on international tax, particularly with reference to financial markets, financing transactions and cross-border mergers.

The U.K. has implemented the controversial diverted profits tax on the profits of multinational companies that are "artificially diverted" from activity within the country. This 25% levy became effective on profits arising on or after April 1, 2015. At this point, it is unclear whether the outcome of the Parliamentary election on May 7 will impact the enforcement of the diverted profits tax, which was enacted without thorough examination by Parliament.

U.K. officials claim multinational corporations are manipulating the tax system and have imposed the 25% levy to prevent companies from avoiding a taxable presence in the U.K. This corporate diversions tax is aimed at entities that transfer profits to lower tax jurisdictions, away from the U.K. The diverted profits tax is being called the "Google tax" because it addresses the practices of well-known international entities such as Google Inc., Amazon.com Inc., and Starbucks Corp. that have used the U.K.'s permanent establishment and economic substance rules to craft tax advantages within the bounds of the law. Legislators have held hearings within the last year on how these three companies in particular have been able to generate billions of dollars in revenue in the U.K. but report little or no taxable profits.

The U.K. tax authority, Her Majesty's Revenue and Customs ("H.M.R.C."), introduced a draft of the diverted profits tax last fall and quickly implemented the legislation ahead of the May 7 election. There is great concern about the legislation's complexity and that its hasty enactment will only result in future revisions, which will further complicate the matter. On the whole, the government is targeting transactions that it does not favor even though they are legal, and the tax itself is being criticized for undermining the Base Erosion and Profit Shifting project executed by the Organization for Economic Cooperation and Development.

The subjective basis for the tax's application is another source of criticism, with the H.M.R.C. calculating and deciding when the tax is imposed. The legislation establishes a framework for determining whether the diverted profits tax will apply to a company's profits, and the rules do not apply to small and mid-size businesses and will not include profits derived from pure loan transactions.

There are two rules that an H.M.R.C. official will utilize in levying the diverted profits tax. The first rule applies to those carrying on activity in the U.K. in connection with the supply of goods and services by a non-U.K. resident company to customers in the U.K., provided that certain enumerated conditions are met. Exemptions apply if the foreign company's or a related company's total sales revenue from all supplies of goods and services to customers in the U.K. does not exceed £10 million ($14.8 million) within a 12-month accounting period. The second rule applies to transactions lacking economic substance that involve entities with a taxable presence in the U.K. It targets activities that exploit tax differentials under certain conditions, including arrangements that result in a tax discrepancy.

According to the H.M.R.C.'s guidance on the newly implemented diverted profits tax, an official will issue a notice to a foreign entity if the H.M.R.C. believes the conditions are met. The guidance details the reasons for imposing the tax and calculates the amount of diverted profits that are taxable. The entity has 30 days to object, and the official may consider certain matters within an additional 30 days in order to issue a charging notice on the original or amended amount or to confirm that there is no charge. The H.M.R.C. officer in specific situations could issue a diverted profit charge reflecting a 30% disallowance of expenses that would otherwise be deductible if the officer considers such expenses to be greater than they would have been under the arm's length standard.

"There is great concern about the legislation's complexity and …its hasty enactment."

A company is required to pay the tax issued on the charging notice within 30 days, otherwise penalties are applied. Companies can appeal the diverted profits tax after the payment's due date. There is review period of 12 months in which the tax can be adjusted based upon sufficient evidence. A company can also appeal any charge resulting from a tax adjustment.

The diverted profits tax was simultaneously implemented as the corporate tax rate was lowered to 20%. Other tax changes that came into effect on April 1 include (i) increasing retail discounts for street shops, pubs, and restaurants; (ii) increasing the bank levy from 0.156% to 0.21%; (iii) enabling certain charities to become eligible for V.A.T. refunds; (iv) reducing the television tax credit from 25% to 10%; (v) new tax relief on the production of children's television; and (vi) restricting the amount of a bank's annual profit that can be offset by carried forward losses to 50%. The Small Business Rate Relief has also doubled in amounts. The government announced these changes are intended to enable companies to reinvest greater funds into further developing existing businesses. Although implementation of the April 1 tax benefits is positive for small and mid-size businesses, there are concerns that the effects of the complex diverted profits tax will deter multinational companies from carrying on significant business activities within the U.K.

As stated in previous *Insights* articles, the diverted profits tax is a political over-reaction to reasonable concern over foreign companies not paying their fair share of tax.[1] Enactment empowers H.M.R.C. to unilaterally override valid tax arrangements – without substantiation that it will achieve the government's goal of preventing tax exploitation – and only further complicates the already intricate tax regime. Ultimately, this creates an uncertain environment that could discourage foreign investment into the U.K.

---

1 Boitelle, Thierry, John Chown, Aliasghar Kanani, and Michael Peggs, "Foreign Correspondence: Notes From Abroad," *Insights* 1, no. 11 (2014).

Chown, John, "The Proposed United Kingdom 'Diverted Profits Tax'," *Insights* 2, no. 1 (2015).