UK TARGETS CORPORATE PROFITS OF MULTINATIONAL ENTERPRISES WITH SWEEPING TAX CHANGES

On December 3, the UK Government announced its intention to introduce a new "diverted profits tax" (DPT) to take effect on April 1, 2015. Draft legislation was published on December 10 and is now subject to a public consultation process until February 4, 2015.

The aim is to "counteract contrived arrangements used by large groups (typically multinational enterprises) that result in the erosion of the UK tax base." The new tax, frequently referred to as the "Google tax," has the potential to significantly increase tax costs for multinational enterprises operating in the UK.

Specifically, DPT will apply in two situations:

- A non-UK entity derives profits from the UK, but is operating in a way that does not give it a UK taxable presence.
- A company has a taxable presence in the UK, but uses entities or transactions with limited economic substance to strip taxable profits from the UK.

In addition to the DPT, the UK is taking a lead in the global debate on base erosion and profit shifting (BEPS), with two other related announcements:

- Hybrid mismatches – the UK Government is consulting on how to counter perceived abuse through cross-border hybrid entities. Any changes to UK domestic law would not come into effect until January 1, 2017.
- Country by country reporting of profits for tax purposes – the UK Government will take powers to introduce this at a future date.

How Will DPT Work?

DPT will be charged at a rate of 25%, which is higher than the maximum UK 20% corporate tax rate. Other features further enhance its deterrence effect, including an automatic interest charge on the tax due; partial disallowance of expenses in the tax calculation; and an affirmative obligation to notify of potential DPT liability.

Guidance was published alongside the draft legislation which gives some idea of what the UK is going after in the application of the tax. For example, arrangements that have received significant publicity in recent months look vulnerable:

- X, a non-UK company, provides online services to customers in the UK.
- X licenses IP from Y, a related non-UK company – the royalty rate leaves X with low profits and Y is located in a country where it pays no tax on its profits.
- The UK sales force is located in Z, a UK subsidiary of X, but all customer contracts are concluded with X.

For DPT to apply, it must be shown to be reasonable to assume that the arrangements between X and Z have been set up to ensure that X does not have a UK permanent establishment – this is likely to be a highly contentious issue. In addition, it must be shown that either the main purpose of the arrangements is it to avoid UK tax (likely also to be a contentious point) or there is a substantial mismatch between the tax paid by X and the tax ultimately paid on the profits derived from the UK. In this example, because Y pays no tax on its royalty income, X faces a DPT charge on the profits it would have made if it had a UK permanent establishment. And, as if the application of DPT was not itself punitive enough, once adjusted under transfer pricing rules, the deduction allowed for royalties paid to Y will be reduced by 30%, effectively increasing the UK tax cost even further.

The second limb of DPT is aimed at UK companies that buy services from related, non-UK entities, for example equipment leases or IP licenses. Transfer pricing rules already allow the UK company's taxable profits to be adjusted – DPT goes much further. For example:

- X, a UK company, seeks to buy IP developed jointly with a third party.
- X holds its existing IP in the UK but chooses to acquire the new IP in Y, a new group company set up outside the UK in a low tax jurisdiction.
- The IP is licensed to X for a royalty.

For DPT to apply, it must be reasonable to assume that the new IP would have been acquired directly by X "but for" the tax savings achieved by using the offshore company. In addition, Y must have little economic substance. The proposed test looks at whether the economic value to the arrangements of Y's involvement is less than the tax reduction. This will depend on factors such as whether Y is merely a passive recipient of the IP royalties or has the staff and resources to develop and maintain the IP.

Issues

With the prospect of DPT, companies must consider the way they organize their operations in the UK and that involve the UK. The April 1, 2015 effective date gives little time for that review, especially as the rules may well change before they become law.

Importantly, fundamental questions raised by DPT remain unanswered. For example, it is not clear how DPT interacts with existing double tax treaties which allocate taxing rights based on the existence of a permanent establishment. Can the UK succeed in deeming a permanent establishment in order to reclaim the right to tax profits derived from the UK where existing treaties might give a different result?

And within the EU, the UK has to tread carefully so that it does not infringe the principle of freedom of establishment – a general rule of equal treatment among EU states – by discriminating against companies that are located in one country but trade with customers in the UK.

Urgency of Timing for Input and Advocacy

The consultation and comment process on DPT runs to February 4, 2015, providing a critical but fleeting opportunity to communicate with UK tax law policymakers.

During that period, the draft legislation will not be scrutinized in the UK Parliament in the typical way. Indeed, the general election in May 2015 means that it may well be voted through without debate shortly before Parliament is dissolved at the end of March.

Critically, then, the consultation process could be the only opportunity to raise concerns with the UK Government and advocate for changes to the DPT framework as currently proposed.

How Squire Patton Boggs Can Help

We will continue to analyze the implications of DPT and will issue a more detailed review in the coming days. In particular, we will focus on the wider ramifications of the UK taking this unilateral step, including how DPT will interact with the UK's existing international obligations under double tax treaties and under EU rules on freedom of establishment. We will also examine how businesses can prepare to operate within the "brave new world" of the DPT regime.

In the meantime, we urge those multinational enterprises potentially impacted to engage in the consultation process. With the depth of Squire Patton Boggs global technical tax expertise, coupled with our seasoned political and policy capabilities, we are uniquely positioned to provide our clients with the strategic counsel and advocacy expertise necessary to effectively engage on this issue.

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