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Through the Looking Glass? The United Kingdom Diverted Profits Tax

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INTRODUCTION

Reacting to the ‘‘gaps and frictions’’ in countries' tax systems and in tax treaties, the Organization for Economic Cooperation and Development (OECD) launched a campaign against base erosion and profit shifting, known as the ‘‘BEPS project,’’ in 2013.[1] To combat ‘‘practices that artificially segregate taxable income from the activities that generate it,’’[2] the BEPS project aims to create greater harmony in the international tax system, such that there will be fewer exploitable mismatches that allow companies to concentrate profits in low-tax jurisdictions or to achieve double nontaxation (such as deductions that are not accompanied by the counterparty's income inclusions).

As the BEPS project has recognized, the rise of multinational enterprises, the emergence of digital commerce, and the expansion of the service sector have dramatically changed the norms of ‘‘doing business’’ in an increasingly globalized world. It is now possible to conduct business around the globe through wholly digital ‘‘e-commerce’’ business models. However, most countries' domestic tax laws — and the permanent establishment (PE) and business profits provisions in Articles 5 and 7 of the 2010 OECD Model Tax Treaty and the 2006 U.S. Model Tax Treaty — require a physical presence in order to subject a foreign corporation to income taxation in the source jurisdiction.

Multinational technology companies, such as Google and Amazon, rely on a combination of e-commerce and carefully planned corporate structures to legally minimize global tax bills. Indeed, as Matt Brittin, a Vice President of Google in the United Kingdom, recently pointed out to a committee of the U.K. House of Commons, legally minimizing costs is a duty to shareholders under U.S. corporate law.[3] To achieve this goal, in addition to other legitimate business reasons, multinationals often locate their European operations in lower-tax jurisdictions, such as Ireland, Luxembourg, or the Netherlands. As a result, many multinational companies maintain PEs only in relatively few countries, and do not have a taxable presence elsewhere under the relevant income tax treaties, as currently worded.

The end-product of BEPS Action Item 7 is revisions to the definition of PE in Article 5 of the OECD Model Treaty. Under the current definition, a company does not maintain a PE in a foreign jurisdiction if contracts for the sale of goods and services in that jurisdiction are negotiated by ‘‘commissionaires’’ that contract in their own names and thus are not ‘‘dependent agents’’ for treaty purposes. The Action Item 7 final report proposes changes that would bring these arrangements within the OECD Model Treaty definition of a PE as well as changes that limit exceptions for preparatory and auxiliary activities that have been artificially fragmented.[4] If implemented through the multilateral convention contemplated by BEPS Action Item 15, these changes to the OECD Model Treaty would presumably induce tax authorities around the globe to assert taxing rights (and companies to re-

[1] OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing (2013), at 9, *available at* http://www.oecd.org/ctp/BEPSActionPlan.pdf.

[2] *Id.* at 10.

[3] House of Commons Committee of Public Accounts, *H.M. Revenue & Customs: Annual Report and Accounts 2011–12* (Dec. 3, 2012), at EV47 (summarizing testimony of witnesses at a parliamentary hearing on Nov. 12, 2012), *available at* http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf.

[4] OECD, *Final Report, BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status* (2015), at 9–10.

structure their operations). The expanded definition (or rather reduced exceptions to PE status), however, generally would not cover all situations in which companies make sales in a jurisdiction remotely, without a subsidiary, branch, or sales or marketing agent.

Parts of the final Action Item 7 proposal directly address the challenges that the digital economy presents with regard to PEs, as discussed at length in BEPS Action Item 1. This action item directly addresses the new tax challenges associated with the digital economy. Often a physical presence in the source country is not necessary for a company to conduct e-commerce. Therefore, e-commerce business models often generate income that is not taxed in the source country (and often untaxed, or taxed at comparatively low rates, in another jurisdiction). This result of nontaxation in the source country would likely not be completely "solved," even if the proposed changes to the definition of PE in the OECD Model Treaty were adopted.

Of course, the interactions described above create a two-way street. Not only do multinational companies seek favorable tax rates; countries seek inbound investment from multinational companies, which contributes to the local economy and (theoretically) expands the tax base. One popular method through which countries entice innovation is the "Patent Box" (or "Innovation Box"), a special tax regime that provides reduced tax rates on income from the licensing or transfer of qualified intellectual property. Another method of attracting business is the provision of favorable tax rulings, such as transfer pricing agreements, to large multinational companies. With regard to the latter, the European Commission (EC), has initiated a series of investigations into whether certain European member states have given impermissible "state aid" (a selective advantage granted by a member state that could distort competition and affect trade between member states) to prominent multinational companies, including Amazon, Apple, and Starbucks. In the tax realm, the EC's ongoing state aid investigations relate to advance pricing agreements and other tax rulings granted by Luxembourg, Ireland, and the Netherlands, as well as the application of entire provisions of domestic law, such as Belgium's excess profits tax.

Because countries compete for the digital tax base as well as profits from highly mobile assets such as intangibles, the BEPS Action Plan predicted that, if the BEPS project were unsuccessful, countries would take unilateral action to protect or expand their sovereign taxing authority, resulting in "avoidable uncertainty and unrelieved double taxation."[5] The subject of this paper — the United Kingdom's Diverted Profits Tax (DPT) — is perhaps the prime example (so far) of the BEPS project's prediction coming to fruition.

In the context of both domestic political pressures and the BEPS-infused international tax landscape, the U.K. government announced the DPT in its Autumn Statement in December 2014. Although the announcement largely surprised the international tax community, in hindsight "the writing was on the wall." In the preceding years, U.K. media outlets had published multiple investigative reports and "tax-shaming" stories highlighting the comparatively small amount of U.K. corporate tax paid by many large multinationals on their U.K.-source revenue.[6] "Tax avoidance" became a phrase in everyday public discourse and a topic of parliamentary hearings.

Known colloquially as the "Google tax" because it targets large multinational companies, particularly those with e-commerce business models, the DPT imposes a 25% tax on the so-called "diverted profits" of large corporations. According to Her Majesty's Revenue & Customs (HMRC), the U.K. taxing authority, the DPT counters "aggressive tax planning techniques" and "contrived arrangements" that erode the U.K. tax base.[7] Effective as of April 1, 2015, the DPT imposes a tax in two distinct situations that involve the use of general tax-avoidance strategies or the exploitation of international tax mismatches. The DPT is innovative because it introduces the concept of a constructive PE (called an "avoided PE" in the statute) that is taxed as if it actually existed. The DPT is potent because it imposes tax based on a "relevant alternative provision," a hypothesized arrangement to which a taxpayer's actual transactions will be compared. The differential in outcomes between the actual and alternative provisions may be taxed as a diverted profit, under certain specified conditions, even if the company's transfer pricing of its actual transactions satisfies the arm's-length standard under U.K. corporate tax law.

Aside from its two targeted applications, the DPT more generally strengthens the existing transfer pricing rules in U.K. corporate tax law by creating additional reporting and enforcement mechanisms, such as a requirement that companies self-report on potential

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[5] OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing (2013), at 11.

[6] Mainstream press stories often compare tax paid with revenues — a misleading comparison.

[7] *H.M. Revenue & Customs, Diverted Profits Tax Consultation Draft, Introductory Statement* (Dec. 2014), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/385741/Diverted_Profits_Tax.pdf.

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DPT liability, which will frequently relate back to the company's potential liability for a transfer pricing adjustment. Therefore, the administrative provisions of the DPT place the onus on the taxpayer to show that it has properly modeled its transfer pricing.

HMRC contends that the DPT comports with and is complementary to the OECD BEPS project.[8] However, the DPT has been widely criticized as unilateral action contrary to the BEPS project's multilateral, consensus-based approach. For example, at the 2015 OECD International Tax Conference, Robert Stack, the Deputy Assistant Treasury Secretary for International Tax Affairs in the U.S. Treasury Department, commented that the DPT's framework was technically flawed and that its introduction demonstrates the U.K. government's lack of faith in the BEPS project.[9]

THE STATUTORY SCHEME

General Structure

The DPT, Part III of the U.K. Finance Act 2015, imposes a 25% tax[10] on a company's deemed diverted profits if, for any given accounting period, the conditions of one of the ''triggering'' provisions and one of the related ''charging'' provisions both are met. The triggering provisions — DPT §§80 and 81 for what will be referred to herein as the ''economic substance'' provisions and §86 for what will be referred to herein as the ''avoided PE'' provision — set out the conditions necessary for a particular company to be subject to the DPT. The charging provisions — §§82 through 85 for the economic substance provisions and §§88 through 91 for the avoided PE provision — define the circumstances under which a company that meets one of the triggering provisions will actually be subject to the DPT. The legislation provides detailed definitions of the various terms and conditions found in the triggering and charging provisions in a separate section of the statute.[11]

The economic substance provisions outlined in §§80 and 81 may lead to a charge on a company that artificially places assets in low-tax jurisdictions, rather than in the United Kingdom — in other words, exploits a tax mismatch. If the arrangement was structured to produce tax benefits that exceed the non-tax economic value attributable to the transaction, the law permits HMRC to substitute for the actual transaction a ''relevant alternative provision'' that does not create a tax mismatch. Typically, the alternative will treat assets held in another jurisdiction as being owned in the United Kingdom.

The avoided PE provision outlined in §86 imposes a charge on a foreign company that sells goods or services to U.K. consumers through an arrangement that skirts the PE definition under tax treaties. The diverted profits of the ''avoided PE'' are potentially subject to tax as if they were profits of an actual PE under U.K. corporate tax law. An ''alternative provision'' may also be substituted by HMRC under this section of the statute.

Administratively, the taxpayer has two responsibilities: (1) a duty to report, and (2) after a preliminary notice has been issued, the burden to show that the DPT should not apply. Companies have a duty to report if it is reasonable to assume that the tax may apply to the company in a given accounting period. As described in greater detail below, the administrative provisions of the DPT force the taxpayer to demonstrate why no charge under the DPT should be levied, rather than placing the burden on HMRC to validate its own charging notice.

The tax assessment process begins with an HMRC officer issuing a preliminary notice to a company, which is to occur within 24 months of the end of the accounting period in question.[12] The company then has 30 days to send written representations to the officer in response to the notice.[13] After considering the taxpayer's representations, HMRC either may abandon the charge or may issue a ''charging notice,'' a formal document that sets the amount of DPT to be imposed and the basis on which the officer believes §80, §81, or §86 applies.[14] Significantly, the taxpayer must pay the tax within 30 days after the charging notice is issued; there is no way to avoid payment during challenge or appeal.[15] Another HMRC officer will review the charging notice within 12 months and may issue, if necessary, an amending notice (called a ''supplementary charging notice'' when it imposes additional tax).[16] Taxpayers have a right to appeal a charging notice or a supplementary charging notice.[17]

The next two sections of this article provide a more detailed overview of the triggering and charging provisions, using examples provided in or adapted from

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[8] Solanki, Anjana, *Officials Look to Next Steps to Halt International Tax*, 34 Tax Mgmt. Weekly Rpt. 30 (July 27, 2015).

[9] Bell, Kevin A., *U.S., U.K., OECD Delegates Differ on Evaluation of BEPS Project*, Int'l Tax. Mon., no. 15 (June 12, 2015).

[10] The main U.K. corporate tax rate is currently 20%. In tax years 2017, 2018, and 2019, it will decrease to 19%. After April 1, 2020, the U.K. corporate tax rate will be 18%.

[11] *See* DPT §106–§114.

[12] DPT §93.

[13] DPT §94.

[14] DPT §95.

[15] DPT §98.

[16] DPT §101.

[17] DPT §102.

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HMRC's Interim Guidance issued in conjunction with the DPT legislation.[18] These examples are very important to an understanding of the DPT and the likely manner of implementation by HMRC.

Economic Substance Provisions

In order to prevent companies from using transactions and entities that "lack economic substance," DPT §§80 and 81 impose a tax on the diverted profits of large multinational companies' related-party transactions that exploit tax differentials.[19] Section 80 applies only to U.K. entities, while §81 extends §80 to foreign companies with a U.K. PE. An economic substance case exists if the following conditions are met: (1) a "material provision" results from a transaction or series of transactions between two parties; (2) the material provision is not an "excepted loan relationship";[20] (3) the two parties meet the "participation condition"; (4) there is an "effective tax mismatch outcome"; (5) the "insufficient economic substance condition" is met; and (6) both parties are not small or medium-sized enterprises. Cutting through this highly complex and interrelated set of conditions — each separately defined in its own multi-part section of the legislation — yields the following: The DPT may apply if a U.K. company or a U.K. PE enters into a transaction with a related party, and (1) the tax paid as a result reduces the total amount of tax to less than 80% of what would otherwise have been paid; (2) it is "reasonable to assume" the arrangement was designed to secure the tax reduction; and (3) the value of the tax reduction exceeds other financial or economic benefits of the transaction.

Even if one of the economic substance triggering provisions is satisfied, tax will be imposed only if additional conditions are met. At the outset, this depends on whether the "actual provision condition" is satisfied. If it is, then determination of the amount of taxable diverted profits, if any, will be based on the arm's-length results of the transaction actually undertaken by the taxpayer. Whether this condition is satisfied, in turn, depends on whether the same deductions would have been allowed under the "relevant alternative provision" — any alternative provision that "it is *just and reasonable to assume* would have been made or imposed as between the relevant company and one or more companies connected with that company" (i.e., commonly controlled companies) instead of the actual material provision imposed "had tax (including any non-UK tax) on income not been a relevant consideration for any person at any time."[21]

On the one hand, if the actual provision condition is met, then the taxable diverted profits amount to any transfer pricing adjustment that would be required under the typical transfer pricing rules in U.K. tax law.[22] In other words, if payments have been set at arm's-length rates and a relevant alternative provision would not lead to a greater U.K. tax liability, there will be no DPT charge, notwithstanding that the arrangement meets the economic substance triggering provision.[23] For example, the actual provision condition is met if a company incurs an actual royalty expense for use of an asset and the relevant alternative provision would also have resulted in the company paying a royalty for the use of the same asset, even if the amount would have been different or the royalty would have been payable to a different (higher-taxed) person, so long as application of the relevant alternative provision would not have resulted in additional taxable income for a connected company.

On the other hand, if the actual provision condition is not met, then the taxable diverted profits will be equal to any required transfer pricing adjustment to the actual provision plus the additional amount of income chargeable to U.K. corporate tax that would have resulted if the relevant alternative provision had been in place rather than the actual material provision. Put simply, if the relevant alternative provision compared to the actual material provision would have yielded a greater tax liability (i.e., the actual provision

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[18] H.M. Revenue & Customs, *Diverted Profits Tax: Interim Guidance v. 1.0* (Mar. 2015) (hereinafter "Interim Guidance"), Foreword, *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/422184/Diverted_Profits_Tax.pdf ("This guidance . . . . explains how the diverted profits tax works by reference to practical examples.").

[19] Each triggering provision contains a limitation that it will not apply if both parties to the transaction are small or medium-sized enterprises. DPT §80(1)(g), §81(1)(c) (referencing the requirements of §80), §86(h). Therefore, the DPT is specifically targeted at large multinational companies, both foreign and U.K. resident, with over 10 million pounds in U.K. sales and either (1) an annual balance sheet total of over 43 million euros or (2) a headcount of 250 or more and annual turnover of at least 50 million euros. DPT §114(1) (defining "small or medium-sized enterprise"); Taxation (International and Other Provisions) Act of 2010 ("TIOPA") §172; *see also* European Commission Recommendation 2003/361/EC, Official J. of the E.U., L 124, at 36 (May 20, 2003).

[20] An excepted loan relationship is defined as an arrangement that only gives rise to one or more loan relationships under §302 or Part 6 of the Corporation Tax Act of 2009.

[21] DPT §82(5) (emphasis added). As we understand it, the relevant alternative provision has much in common with the "realistic alternative" concept contained in the transfer pricing regulations from the U.S. Treasury. *E.g.,* Reg. §1.482-1(d)(3)(iv)(H), §1.482-3(b)(2)(ii)(B)(8). These regulations are based on the principle that parties acting at arm's length will consider all possible arrangements and will "only enter into a particular transaction if none of the alternatives is preferable to it." Reg. §1.482-3(e)(1).

[22] *See* DPT §84; Interim Guidance, ¶ DPT1136; *see also* TIOPA Part 4.

[23] *See* DPT §83.

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condition is not met), the taxable diverted profits include the difference in taxable income and any required transfer pricing adjustment.

An illustration may help in understanding both the triggering and the charging provisions applicable in an economic substance case. Company A, a U.S. multinational corporation, wholly owns Subsidiary B, which is subject to a 20% tax rate in the United Kingdom, and Subsidiary C, located in a jurisdiction with a 5% corporate tax rate. Subsidiary B manufactures and distributes a finished product in the United Kingdom and pays to Subsidiary C an annual intracompany licensing fee of 100 million pounds in order to use the intellectual property owned by Subsidiary C. Subsidiary C has a very small staff and conducts neither administrative activities nor its own research and development activities.

For purposes of the DPT, Subsidiary B and Subsidiary C meet the participation condition because they are owned by a common parent, Company A. The intercompany licensing agreement between Subsidiary B and Subsidiary C is the material provision under the DPT, and it is not an excepted loan relationship. Under the intercompany licensing agreement, Subsidiary B makes a deductible royalty payment to a lower-tax jurisdiction, which leads to an effective tax mismatch outcome because (1) it results in expenses to Subsidiary B for which a deduction is taken; (2) the resulting 20-million-pound reduction in Subsidiary B's U.K. tax liability exceeds the 5-million-pound increase in Subsidiary C's foreign tax liability; and (3) the 80% payment test is not met because the 5-million-pound increase in foreign tax liability is not at least 16 million pounds, or 80% of the relevant U.K. tax reduction.[24]

HMRC would then analyze whether the material provision meets the insufficient economic substance provision — i.e., whether it is reasonable to assume that the intercompany licensing agreement was designed to secure the tax reduction and the non-tax benefits during the duration of the agreement do not exceed the financial benefit of the tax reduction. (In practice, Company A or Subsidiary B would have the responsibility of demonstrating economic substance.) Given the relevant facts, it is not unreasonable to assume that Company A's international intellectual property was transferred to Subsidiary C in order to secure a tax benefit and that there are no significant financial or economic benefits — i.e., "income attributable to the ongoing functions or activities of the staff" of Subsidiary C — attributable to the chosen structure.[25] Therefore, the requirements of an economic substance case under §80 are satisfied.

The determination of whether there is DPT liability hinges on the application of the economic substance charging provisions. The first step is to identify the relevant alternative provision, which requires the development of additional facts. In the first scenario, Subsidiary B conducts its own research and development activities related to the intellectual property it licenses from Subsidiary C. Company A's general practice is to hold its intellectual property either in Subsidiary C or in the subsidiary in which the research and development activities take place. Under these circumstances, the relevant alternative provision would be Subsidiary B owning the intellectual property instead of licensing it from Subsidiary C. In this scenario, the actual provision condition is not met — i.e., calculation of the amount of taxable diverted profits is not limited to arm's-length results from the actual material provision undertaken — because Subsidiary B would not have as an expense a deductible licensing fee if it owned the relevant intellectual property.[26] Therefore, the DPT charge is calculated under §85 and would equal 25% of the additional amount of Subsidiary B's profits subject to U.K. corporate tax had the relevant alternative provision been in place, i.e., had the 100-million-pound deduction for the intracompany royalty not been taken.

In the second scenario, Company A develops valuable intellectual property in the United States and retains the domestic rights but transfers the worldwide rights to Subsidiary C. Under these circumstances, the Interim Guidance reasons that the relevant alternative provision would have been Subsidiary B licensing directly from Company A the relevant intellectual property and paying to Company A the 100-million-pound royalty. Here, the actual provision condition is met because Subsidiary B would still have made a deductible royalty payment of the same type and for the same purpose. Therefore, the taxable DPT would equal the transfer pricing adjustment, if any, that is required under the normal U.K. transfer pricing rules, as applied to the relevant alternative provision, beyond any adjustment already made under Part 4 of TIOPA 2010. In other words, a transfer pricing analysis of the hypothetical relevant alternative provision — i.e., the proper arm's-length amount of a royalty payment to Company A — is required.

[24] *See* DPT §107(3)(a)(1), §107(3)(b), §107(3)(d), §107(7).

[25] Interim Guidance, ¶ DPT1320, *Ex.* 1.

[26] *See* DPT §82(7)(a)(i).

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Avoided PE Provisions

DPT §86 taxes large foreign companies that avoid creating PEs in the United Kingdom by treating those companies as if they actually had U.K. PEs.[27] As in economic substances cases under §80, described earlier, the triggering provision for an avoided PE case contains a set of complex conditions, outcomes, and provisions. At base, §86 applies when (i) a foreign company supplies goods or services to customers in the United Kingdom through another person or entity; (ii) it is ''reasonable to assume'' that the arrangement is designed to ensure that the foreign company does not have a U.K. PE; and (iii) either (A) the mismatch condition or (B) the tax avoidance condition is present.

To understand the avoided PE provisions, a closer look at each of the two alternate conditions is necessary. The latter has a relatively short (though certainly not straightforward) definition: The tax avoidance condition is met if the ''main purpose or one of the main purposes'' of the arrangement to supply goods or services to U.K. customers ''is to avoid a charge to corporation tax.''[28] The former is more complex but largely mirrors the requirements of §80. To meet the §86 mismatch condition, (i) there must be a ''material provision'' resulting from a transaction or series of transactions between two parties that meet the ''participation condition''; (ii) there must be an ''effective tax mismatch outcome''; (iii) the ''insufficient economic substance condition'' must be met; and (iv) the parties may not be both small or medium-sized enterprises. Similar to §80, these conditions are generally satisfied when a foreign company and a connected entity enter into an arrangement in which the profits of the foreign company are taxed at a rate lower than 80% of the U.K. corporation tax rate, the value of the tax reduction exceeds other financial or economic benefits of the arrangement, and it is reasonable to assume that the avoided PE arrangement was designed to secure the resulting tax deduction. Even if the avoided PE has a legitimate commercial purpose, it still may be ''reasonable to assume'' that the arrangement was created to ensure that the foreign company does not maintain a PE in the United Kingdom.

In addition to the requirement that either the foreign company or the avoided PE be a large business, there are three notable exceptions to §86. First, companies whose U.K.-related sales do not exceed 10 million pounds or whose U.K.-related expenses do not exceed 1 million pounds are excepted under §87. Second, a foreign company that carries on business ''through an agent of independent status acting in the ordinary course of the agent's business'' that would be covered under 2010 Corporation Tax Act §1142 is excepted, subject to certain other requirements. Finally, certain alternative financing arrangements are excepted.[29]

If §86 is triggered, then the foreign company's taxable diverted profits equal its ''notional PE profits'' — the profits that would have been taxable to the foreign company under Corporation Tax Act of 2009 §§20 to 32 had the avoided PE been an actual PE under that Act.[30] Similar to the charging provisions in an economic substance case, the charging provisions in an avoided PE case where the mismatch condition is met also require comparison of a hypothetical ''relevant alternative provision'' to the actual material provision in order to determine whether there is an additional charge. In such a case, if the actual provision condition is not met, in addition to the notional PE profits calculated under the normal rules, the diverted profits would include the additional amount of U.K. profits that would have resulted if the relevant alternative provision had been in place rather than the actual material provision.

Two examples adapted from the Interim Guidance best illustrate the operation of these rules. In example one, Company A is a U.S. corporation that operates Company B as its European sales company, which concludes all contracts of Company A in the European market; Company B is located in a country with a tax rate of 5%. However, the contracts concluded by Company B are negotiated in the United Kingdom by Company C, a U.K. sales support company, to which Company B pays a service fee. In the first scenario, Company B carries on some activities in the United Kingdom in connection with the sale of goods to U.K. consumers, and it is considered reasonable to assume that the use of Company C, a U.K.-based sales company, was solely employed so that Company B's U.K. activities did not rise to the level of a PE under the relevant income tax treaty or the U.K. corporation tax. Therefore, the tax avoidance condition is also met because one of the main purposes of the arrangement was to avoid or reduce the charge to corporation tax.[31] Note that §86 may be satisfied even if the use of a

[27] *See* above n. 19.

[28] DPT §86(3).

[29] DPT §86(5)(a); *see also* 2010 Corporation Tax Act §1144.

[30] DPT §88(5), §89(2), §90(2), §91(4)(a), §91(5)(a). Presumably this would implicate an Article 7 analysis, and possibly the ''authorized OECD approach'' to PE profit attribution, in treaty situations.

[31] For a case to fall under §86, either the tax avoidance condition or the mismatch condition must be satisfied. One of the requirements of the mismatch condition is that the avoided PE and the foreign company be connected companies. That condition is not satisfied here. See the illustration in ''Economic Substance Provisions,'' above, for an analysis of the mismatch condition.

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U.K. sales company also secures other commercial, non-tax objectives.[32]

Under this scenario, the amount of diverted profits equals the notional PE profits. The notional PE profits are simply the amount that would have been the taxable profits of the foreign company, attributable under Corporation Tax Act of 2009 §§20 to 32, had the PE been an actual PE. In other words, the avoided PE is treated as a constructive PE and attributable profits are taxed to the foreign company as if it actually were a PE. A detailed analysis of the functions and risks of Company B is necessary to determine the amount of the profits attributable to the avoided PE.[33]

The second example assumes the same basic facts. However, Company B has a large staff of qualified people that negotiate the terms of contracts with customers in the United Kingdom and other European jurisdictions, and Company B is generally in charge of marketing and advertising as well as customer relations throughout Europe. Company C, a U.K.-based sales support company, actually supports the commercial role of Company B, and the service agreement between the two companies reflects an arm's-length amount paid by Company B for the services performed by Company C. Under these circumstances, the tax avoidance condition of §86 is not met, because one of the main purposes of the arrangement is not considered to be the avoidance of or a reduction in liability for U.K. corporate tax.[34]

OPEN QUESTIONS

Interaction with U.K. Treaty Obligations

Because the DPT effectively taxes as PEs arrangements that do not meet the treaty definition of a PE, the DPT arguably conflicts with U.K. obligations under international law. HMRC has taken the position that the DPT is not a tax covered under Article 2 of the U.K. income tax treaties because it is separate and distinct from the U.K. income tax, capital gains tax, and corporation tax.[35] HMRC argues that the DPT is not a tax ''substantially similar'' to an income tax despite the Interim Guidance clearly acknowledging elsewhere that a company's diverted profits ''are computed using the same principles which apply for corporation tax, including transfer pricing rules, except where the legislation requires arrangements to be recharacterised.''[36]

Alternatively, HMRC contends that even if the tax were covered by the U.K.'s tax treaties, ''the arrangements it targets are the kind where there is no obligation to provide relief under international law'' because the DPT targets only those ''arrangements designed to exploit the provisions of tax treaties to avoid tax.''[37] This position is consistent with the Commentary to Article 1 of the OECD Model Tax Convention, which generally condones the use of domestic tax law or jurisprudential rules to counter abusive tax practices that are contrary to the purpose of the convention.[38]

By making such arguments, HMRC implicitly acknowledges the conflict: A foreign corporation may ''dot its I's and cross its T's'' in setting up a structure that comports with its treaty obligations, but still be taxed in a manner contrary to that outlined in Article 7 of the OECD Model Treaty (the same article as in most U.K. income tax treaties), which governs whether one contracting state may tax an enterprise of the other contracting state, including by the attribution of profits to PEs.[39] The question of treaty override with respect to Articles 5 and 7 of the U.K. tax treaties may diminish in practical importance if the BEPS project is successful in amending the OECD Model Treaty definition of PE in Article 5 to include many independent agents as well as preparatory and auxiliary activities. Moreover, if in practice HMRC limits application of the DPT to arrangements that may be considered to constitute treaty abuse, then the OECD Model Treaty commentary could provide sufficient basis to defend the DPT.[40]

The U.K. government is signaling that a company must actually establish a PE in order to be afforded the protections of having one under the U.K. tax treaties and U.K. corporate law. Otherwise, the company may be subject to greater tax, yet unlikely to receive protection under the nondiscrimination provisions contained in the U.K. tax treaties. Both PEs and U.K.

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[32] DPT §86(1)(e).

[33] Interim Guidance, ¶ DPT1310 *Ex.* 1.

[34] *Id.*, *Ex.* 2.

[35] Interim Guidance, ¶ DPT1690. As a result, the Interim Guidance also concludes that Advance Pricing Agreements with treaty partners may not cover the DPT. *Id.*

[36] Interim Guidance, ¶ DPT1010.

[37] H.M. Revenue & Customs, *Presentation on the Diverted Profits Tax* (Jan. 8, 2015), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/400340/Diverted_Profits_Tax.pdf.

[38] OECD Model Treaty, Commentary to Article 1 (2010), §§7–8, *available at* http://www.oecd.org/berlin/publikationen/43324465.pdf; *see also* §9.4 (''States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.'').

[39] Article 7(1) of the 2010 OECD Model Treaty provides that profits of an enterprise of one contracting state are only taxable in that state unless the enterprise carries on business in the other contracting state through a PE.

[40] *See* above n. 38.

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corporations are taxed at the 20% U.K. corporate tax rate, while profits attributable to an avoided PE are taxed at a 25% rate under the DPT. Although Article 24(3) of the OECD Model Treaty provides that a contracting state may not tax PEs less favorably than enterprises established in that state, the provision is unlikely to apply to shield an avoided PE from the DPT's higher tax rate. After all, an avoided PE that does not meet the treaty definition of a PE would not fall within the scope of Article 5. Put simply, the DPT may induce multinational companies to actually establish PEs, as defined in Article 5, to receive the protections afforded by the nondiscrimination clause (and other treaty provisions).

Creditability

If the taxpayer has already paid the U.K. corporation tax or a foreign country's corporation tax on the same profits, the taxpayer will receive a ''just and reasonable'' credit against the DPT for those amounts.[41] However, the DPT is not deductible or creditable against other U.K. taxes,[42] and, consistent with its position *vis-à-vis* the applicability of Article 5, HMRC takes the position that the DPT is not creditable under U.K. tax treaties. Whether the DPT will be considered creditable under U.S. Internal Revenue Code §901 or §903 remains an open question, and will likely depend at least partially on how the DPT is applied in practice.[43] Particularly if the relevant alternative provisions are widely used to calculate a DPT charge that includes in companies' income profits that they do not actually earn, there is a risk that the DPT would not be considered to be a tax based on gross receipts or net income. Furthermore, as the DPT has the potential to impute constructive ownership to U.K. entities, it may require inclusion of hypothetical income that is not actually realized or recognized by a taxpayer (such income, of course, could also cause the tax to fail the gross receipts test).[44] On the other hand, if the DPT is applied conservatively, and consistently with normal transfer pricing principles, then the risk of U.S. noncreditability will diminish.

Interaction with BEPS

Although the DPT specifically targets the e-commerce business models of large multinational corporations such as Google and Amazon, its potential application is much broader. As illustrated in the discussion above, the DPT introduces broad, ill-defined terms and concepts that could bring into its scope almost any business that operates in countries with a significant tax rate differential. It remains to be seen, however, whether the DPT's ''bite'' will match its ''bark.'' Given HMRC's resource constraints, and in light of the political provenance of the statute, it is possible that HMRC will use the law to highlight and tax only the most aggressive planning behavior (e.g., outbound transfers of U.K.-generated intellectual property). Even assuming restrained application, however, the United Kingdom provides an example for other jurisdictions, such as Australia, that are following suit. Others too may decide to initiate aggressive, unilateral anti-BEPS regimes rather than waiting until BEPS reforms have been fully implemented.

In the current international tax disequilibrium, more countries are asserting bold claims to a greater share of the global corporate tax base. These claims take many forms, from the expansion of traditional PE concepts (''virtual PEs'') to aggressive application of profit split methods. If every country passed its own DPT, without coordination or any mechanism to resolve resulting disputes, the adverse impact on global trade could be substantial. A single item of intellectual property held in a low-tax jurisdiction could be treated as owned and taxable under multiple ''relevant alternative provisions,'' and profits from the intellectual property would be considered ''diverted'' from multiple jurisdictions. The dangers are easily imagined, relating back to the original BEPS Action Plan's warning that unilateral action to close perceived tax loopholes could significantly increase the incidence of multiple taxation of the same profits.

Practical Incongruities

The practical application of the DPT rules is obviously complex, particularly because both the triggering and charging provisions rely on a combination of alternatives and assumptions that give HMRC significant interpretive power. For example, both triggering provisions require a reasonable assumption that the material provision was designed to secure a reduction in taxes. However, neither the legislation nor the Interim Guidance provides clarity as to exactly when such an assumption is reasonable. Similarly, the entire charging structure depends on an ill-defined hypothetical alternative, or (perhaps more likely) an entire universe of hypothetical alternatives, limited only by the open-ended standard of what is ''just and reasonable.'' By defining the triggering and charging structure in this manner, while simultaneously placing the burden on the taxpayer to show that the arrangement

[41] DPT §100.

[42] DPT §99.

[43] *See PPL Corp. v. Commissioner*, 133 S. Ct. 1897 (2013) (''[W]e apply the predominant character test using a commonsense approach that considers the substantive effect of the tax.''). *See also Exxon Corp. v. Commissioner*, 113 T.C. 338, 359–60 (1998); *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256, 313–15 (1995).

[44] *See* Reg. §1.901-2(b)(3)(i), §1.901-2(b)(4)(i); *but see* Reg. §1.904-6(a)(1)(iii).

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is not subject to the DPT, the legislation effectively forces the taxpayer to show that *no* other possible structure or transaction could have resulted in greater U.K. tax liability. For example, a U.K. subsidiary that makes royalty payments for intellectual property long held by a sister company in a lower-tax jurisdiction may now face the burden of explaining why the foreign parent did not place those resources in the U.K. at the outset.

Demonstrating that non-tax financial benefits in fact outweigh any tax benefits to the structure or transaction may require costly economic studies — in essence, a second set of transfer pricing documentation. In the context of the DPT (as distinguished from the detailed guidance in the OECD Transfer Pricing Guidelines and the U.S. Treasury Regulations under tax code §482), the taxpayer has little guidance as to the type of proof necessary, or what types of alternative transactions must be reviewed, to carry the taxpayer's burden. This difficulty is exacerbated because the DPT was designed to target the e-commerce business models of many technology giants, and its practical application to other sectors or business models is not contemplated by the Interim Guidance. Finally, it is not clear in a complex multiparty structure exactly which parties must be analyzed. For instance, in the first example of the avoided PE scenario, discussed in ''Avoided PE Provisions,'' above, it is not clear whether a separate analysis must be conducted for each foreign company in the chain of the sales to the U.K. customers — i.e., whether a unique, but similar, analysis must be conducted with respect to each of Company A (the U.S. parent) and Company B (the European sales company).

There are several ways to ease the burden on the taxpayer. First, HMRC could clarify that a DPT analysis must be conducted only with respect to group members that have some economic or functional connection to the source country activity. Second, a safe harbor for companies that have had their current structure in place for a certain period of time could be introduced. Third, guidance could be expanded in order to further limit the universe of ''just and reasonable'' alternative provisions that must be compared to the actual material provision. Although the Interim Guidance provides that a relevant alternative provision will not lead to DPT liability unless the intellectual property at issue would have been held in the United Kingdom (as opposed to a different foreign jurisdiction), the taxpayer still has the burden of showing why the U.K. ownership alternative would *not* be the relevant alternative provision.

Because of the heavy burdens that the DPT places on taxpayers, its greatest impact (and certainly one of its intended effects) is likely to be deterrence of international tax planning that capitalizes on mismatch outcomes between the United Kingdom and lower-tax jurisdictions. This effect is likely to be strongest in the context of the DPT's innovative avoided PE provisions that tax foreign corporations as if they operated through a PE. As of May 1, 2015, Amazon began recording sales made in the United Kingdom, Germany, Spain, and Italy in each respective country, rather than in its Luxembourg subsidiary.[45] It is unclear exactly what caused this change — the EC's state aid investigations, the U.K. DPT, other policy pressures, or a combination thereof. However, it is possible that other large multinationals will begin to record additional income in the United Kingdom, or pursue the protection provided by advance pricing agreements,[46] rather than face the possibility of paying noncreditable tax under the DPT.

CONCLUSIONS

Because the DPT is written so broadly, many of the unresolved questions about its application will be answered by how HMRC chooses to enforce the law in practice. In one scenario, the DPT will cause a charge to be levied only in a handful of clear-cut cases, under circumstances where significant business is conducted through nominally independent agents or where the transfer pricing of a related-party transaction is clearly flawed. In this scenario, the DPT would be another administrative tool available to HMRC to identify and police abusive transactions and to enforce existing transfer pricing rules. However, given the seemingly unfettered availability of ''relevant alternative provisions'' that could be used to convert foreign income into profits ''diverted'' from the United Kingdom, one can imagine another scenario in which many companies fall within the scope of the DPT, significantly expanding the U.K. tax base.

Even in the former, perhaps more likely, scenario, the DPT will have significant repercussions, both for multinationals doing business in the United Kingdom and in the broader context of the BEPS project. Beyond the DPT's specific application to large multinationals with operations in the United Kingdom, the tax has now introduced the concept of a ''diverted profit'' to the lexicon of international taxation. By fiat, through the DPT, the United Kingdom has staked its claim to a potentially greater share of the global tax base than it is entitled to claim under current interna-

[45] Scott, Mark, *Amazon to Stop Funneling European Sales through Low-Tax Haven*, N.Y. Times (May 24, 2015), *available at* http://www.nytimes.com/2015/05/25/technology/amazon-to-stop-funneling-european-sales-through-low-tax-haven.html.

[46] For all APAs entered into after April 1, 2015, HMRC will require information on the DPT potential related to the covered transaction. Interim Guidance, ¶ DPT1710.

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tional rules for allocating taxing rights. Other countries already have followed suit, and more are likely to do so. In this sense, the DPT may well be the first step in fulfilling the BEPS Action Plan's prophecy of a global revenue grab, as countries seek to expand their tax bases to cover outbound payments that are more lightly taxed in the country of destination.

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