Tax Journal/2015/Issue 1247, 23 January/Articles/Analysis - The diverted profits tax and EU/international law issues - Tax Journal, Issue 1247, 8

Tax Journal
Thoughtful commentary-by tax experts, for tax experts.
Tax Journal, Issue 1247, 8

23 January 2015

Analysis - The diverted profits tax and EU/international law issues

Peter Cussons

is an international corporate tax partner with PwC. He specialises in advising on cross-border situations, including tax treaties, EU law and also tax litigation and expert witness work. Email: peter.cussons@uk.pwc.com; tel: 020 7804 5260.

Speed Read: The new diverted profits tax (DPT) raises a number of challenges that need to be worked through. It's questionable whether the DPT, as currently drafted, is EU law compliant. The new tax is not restricted to 'wholly artificial arrangements' (as required by Cadbury Schweppes); nor is it confined to 'purely artificial arrangements entered into for tax reasons alone' (per Thin Cap GLO). The opaque drafting of the legislation is unlikely to meet the test identified in SIAT of providing sufficient legal certainty. Further, the rate of the DPT -- which will be significantly higher than the CT rate -- might be regarded as penal. As such, it would appear to attract the protection of art 6 of the European Convention on Human Rights. Moreover, insofar as the nondiscrimination articles of UK tax treaties follow the OECD model, they apply to all taxes and not just to the art 2 taxes covered by the treaty. Lastly, the DPT anticipates the outcome of BEPS action 7 regarding permanent establishments (PEs), and may not be consistent with whatever is agreed by the G20/OECD later this year.

On 10 December 2014, HMT and HMRC published the draft diverted profits tax (DPT) legislation for inclusion in the 2015 Finance Bill, to be enacted by the end of March 2015 and effective from 1 April 2015, i.e. ahead of the 7 May 2015 general election.

A Parliamentary debate was held on 7 January, and the Labour party broadly indicated that it would support the Coalition's DPT proposals.

EU law

At an open day on 8 January 2015, HMT and HMRC said they had taken 'considerable care ... to ensure compliance with EU law' and that 'the tax is also proportionate'. However, it is likely that the DPT will be challenged on both these counts when looking at comparable cases across EU law. The DPT is avowedly an anti-avoidance measure. As well as not being corporation tax (to sidestep the UK's 130 plus tax treaty obligations), it is at a significantly higher rate of 25%, compared with 20% corporation tax in financial year 2015. This means it must meet the tests in the *Cadbury* case (C-196/04) and (in the author's view) the *Thin Cap GLO* (C-524/04) and *Itelcar* (C-282/12) cases.

Cadbury Schweppes**:** In the *Cadbury Schweppes* case, the CJEU decided that the former UK controlled foreign companies (CFCs) regime would not be EC Treaty compliant unless it only targeted 'wholly artificial arrangements' (para 76). This was to be evaluated with regard to 'the extent the CFC exists in terms of premises, staff and equipment' (para 67).

Section 7 of the DPT (the insufficient economic substance condition) is applied both for the s 2 (mismatch PE) and the s 3 (involvement of entities lacking economic substance) charging situations. It works by comparing the financial benefit of the (overall) tax reduction with other financial benefits, and deeming the arrangement to be a diversion of profits subject to the DPT if the tax benefits are greater than the other financial benefits. That is not what the CJEU said in the *Cadbury* case, however.

Cadbury's Irish international financial services centre (IFSC) treasury companies were subject to the 10% IFSC tax rate in Ireland, in comparison with the then 33% rate (1996) of UK corporation tax. The 23% tax rate advantage on the Irish subsidiaries' profits must surely have considerably outweighed any other benefits of setting up the treasury operations in Ireland, whether to do with its non-tax location or other financial benefits.

Paragraph 49 of the *Cadbury* judgment memorably reads: 'it is settled case law that any advantage resulting from the low taxation to which a subsidiary established in a member state [MS] other than the one in which the parent company was incorporated is subject cannot by itself authorise that MS to off set that advantage by less favourable tax treatment'.

The issue is well illustrated by the situation of a US group that has chosen to locate European intellectual property (IP) in, say, a Cypriot company with the appropriate significant people functions (SPFs); however, it benefits from the 2% Cyprus IP box rate and protection from US sub-part F. Such a situation will very likely fail the DPT s 7 test, but it will not be a 'wholly artificial arrangement'.

Admittedly, the DPT is an anti-avoidance regime regarding inbound investment into the UK, whereas the *Cadbury* case (on CFCs) concerned outbound investment elsewhere in the EU -- so the relevant TFEU freedom is likely to be either the freedom to provide services, especially for the s 2(4) UK tax avoidance PE that doesn't require the participation condition to be met, or the freedom of establishment, rather than just freedom of establishment. But this of itself is unlikely to allow *Cadbury* to be distinguished, though, as the CJEU approaches all the freedoms in much the same way, except for third country free movement of capital.

Thin Cap GLO**:** *Thin Cap GLO* said that the pre-FA 2004 thin cap rules were precluded by art 43 EC (freedom of establishment) 'unless ... that legislation provides for a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, *entered into for tax reasons alone*' (para 92, emphasis added). See also *Itelcar* para 37. The DPT is an anti-avoidance provision. However, s 7 of the DPT draft legislation is not (as discussed above) a test for 'wholly artificial arrangements', nor is the DPT confined to 'purely artificial arrangements entered into for tax reasons alone'.

Legal certainty? Moreover, the drafting of the DPT legislation is dense and would be unlikely in the author's view to meet the legal certainty test set out in the *SIAT* (C-318/10) case. *SIAT* was a Belgian referred case where the CJEU held that Belgian tax law requirements that were more exacting for allowing the deduction of cross-border payments than for domestic payments (payments to another Belgian person) were disproportionate. This was mainly because of the absence of legal certainty as to what the taxpayer had to do to justify a tax deduction.

The provisions of the DPT which allow HMRC to recharacterise the actual transaction(s) and hypothesise what a 'just and reasonable' replacement transaction might have been are surely too imprecise to meet the EU law legal certainty standard as required by *SIAT*. See also *Itelcar* (para 44).

A penal rate? Moreover, the DPT is set at 25%, a rate which will be higher than the possible 20% main corporation tax rate in the next Parliament. As such, and insofar as the UK continues to adhere to the European Convention on Human Rights, it would appear to attract the protection of art 6 of the Human Rights Convention and the related case law as a penal regime and the criminal law right to a fair trial.

The DPT has been triggered partly by the (non-consensus) OECD discussion draft on BEPS action 7 (preventing the artificial avoidance of PE status), published on 31 October 2014. While the tax has cross-party support, recent CJEU case law suggests it is likely to be challenged at the CJEU, if enacted as drafted.

International law: tax treaties

HMT and HMRC have been quite explicit in acknowledging that the DPT is designed as a separate tax from corporation tax. This is to prevent the DPT being blocked by the UK's tax treaty network. The art 2 definition of taxes for the purposes of most UK tax treaties is confined to income tax, corporation tax, capital gains tax, petroleum revenue tax and any substantially similar subsequently enacted taxes. The argument is that the DPT is not substantially similar to corporation tax.

There is some discussion of this, but arguably little support, in the Court of Appeal decision in *Bricom Holdings Ltd v CIR* (1997) 70 TC 272 regarding the UK CFC charge and the Dutch/UK treaty. Moreover, some treaties, such as the UK/ Italy treaty, adopt the OECD model's expanded definition of taxes in the non-discrimination article as 'taxes of every kind and description', which would include the DPT.

If such an article (as with Italy) also includes the paragraph about payments to enterprises of the other state being deductible under the same conditions as payments to enterprises of the UK, this would particularly appear to provide another basis for challenge. This would, though, be subject to the issue of whether TIOPA 2010 s 6 relevantly enables such non-discrimination articles; see *NEC Semi-Conductors ltd & Others v IRC (also known as Boake Allen Ltd)* [2007] STC 1265.

If not, as well as approaching the other state's competent authority, there is always the avenue of an action at the International Court in The Hague regarding the UK observing all its tax treaty obligations, the UK being a signatory to the Vienna Convention.

BEPS

The UK is enacting the DPT ahead of the final outcome from the OECD/G20 regarding action 7 (preventing the artificial avoidance of PE status). As such, the DPT may or may not be consistent with the (as yet unknown) final outcome. In the parliamentary debate, this was raised in questioning around whether the DPT was here to stay or not. This is to say the least unfortunate.

US creditability of the DPT

The creditability of the DPT for US foreign tax credit purposes is being considered by the US Treasury. However, its view will presumably not be available until after the DPT legislation is enacted in late March.

Copycat DPTs?

The UK's action in enacting the DPT ahead of the consensus outcome of BEPS action 7 may encourage other BEPS countries to do something similar. Indeed, Australia is reported to be interested in implementing a similar levy. It is not clear that other DPTs would be (unilaterally) creditable against UK corporation tax, particularly if they too are considered not to be 'substantially similar' subsequently enacted taxes to the other country's corporation tax.

Conclusion

The draft clauses raise many questions that are not currently fully answered. Some of the issues, such as EU law compatibility, are fundamental, as many of the arrangements targeted involve EU non-UK companies.

Representations and comments are invited by 4 February 2015, so businesses/representative bodies will doubtless wish to make use of this opportunity to push for more clarity around the scope and vires of the DPT.

* * * * * *

For related reading, visit www.taxjournal.com

Diverted profits tax: give BEPS a chance (Heather Self, 15.12.14)

News: MPs debate diverted profits tax (15.1.15)

Q&A: Autumn Statement 2014 -- examining the big picture (Chris Sanger, 5.12.14)

Tax treaty briefing (Allan Cinnamon, 15.1.15)

* * * * * *

For further tax guidance, see www.taxjournal.com.