Base Erosion and Profit Shifting: UK contra mundum?

October 2016

Introduction

There has been an increasing focus in recent years, both in the UK and internationally, on multinational companies exploiting weaknesses in international tax rules that allow them to shift profits to low-tax jurisdictions where there is little or no economic activity.

Recognising the global nature of the problem, the G20 finance ministers in 2012 asked the OECD to produce a report on what could be done to counter "base erosion and profit shifting" ("**BEPS**").

In February 2013, the OECD published *Addressing Base Erosion and Profit Shifting* (the "**BEPS Report**"). Following up on the BEPS Report, the *Action Plan on Base Erosion and Profit Shifting* (the "**BEPS Action Plan**") was published in July 2013 and proposed 15 Actions to counter BEPS. In October 2015, the OECD published its considered recommendations for reform. With over 100 countries involved, the BEPS project aims to bring together the world's larger economies in a unified effort to reform the way in which companies are taxed.

The second chapter in this year's edition, contributed by Sandy Bhogal and Ben Fryer of Mayer Brown, reviews Actions 2 and 4 – concerning, respectively, hybrids and interest deductibility – and looks at legislation that the UK is introducing in these two areas. It could be said that the UK is acting a little prematurely here since the OECD's work is not yet complete, and I should like to focus on some other BEPS-related changes made by the UK where that charge can hardly be denied.

The changes are, firstly, the introduction last year (April 2015) of a new diverted profits tax (the "**DPT**") and, secondly, a number of significant amendments this year to the UK's rules governing the imposition of withholding tax on royalties. Both of these developments extend the scope of the UK's tax rights, either through application of the permanent establishment principle or through the sourcing of payments, and both have proved controversial. Although the UK government considers that these changes complement what the OECD is trying to achieve, many view them as the over-hasty actions of a government trying to be seen to be doing something in the face of public pressure.

BEPS Action 7: Artificial Avoidance of PE Status

Before plunging into the DPT, it is instructive to consider the OECD's proposed answer to one of the two issues targeted by the UK's new tax, namely Action 7 of the BEPS Action Plan: preventing the artificial avoidance of permanent establishment ("**PE**") status.

Tax treaties generally provide that the business profits of an enterprise are taxable in a state only to the extent that the enterprise has a PE in that state. The OECD's *Model Tax Convention on Income and Capital* (the "**Model Convention**") is widely used as the basis for double tax treaties and the definition of PE in Article 5 of the Model Convention is thus central to whether an enterprise pays tax in a jurisdiction: avoid creating a PE within the Article 5 definition, and you avoid having a taxable presence.

The OECD's final report on Action 7 recommended changes be made to Article 5 to target avoidance of PE status through:

- "commissionaire" arrangements and similar strategies: the wording of paragraph 5 will be amended so as to prevent multinationals avoiding the creation of a PE through the use of non-binding commissionaire arrangements and similar strategies;
- perceived abuse of the specific-activity exemptions: the list of these exemptions is to be amended and an anti-fragmentation rule brought in; and
- "other strategies": a new anti-abuse rule will prevent the practice of artificially splitting up contracts between group companies to circumvent the 12-month threshold for creating a PE through a construction contract.

It is the proposed changes to paragraph 5 of Article 5 that are the most important of the Action 7 package. As currently drafted, Article 5 provides that an enterprise will have a PE in a jurisdiction if: (i) it has a fixed place of business in that jurisdiction through which its business is wholly or partly carried on (paragraph 1); or (ii) a person in that jurisdiction acting on behalf of the enterprise has and habitually exercises authority to conclude contracts in the name of the enterprise (paragraph 5). The current wording of paragraph 5 allows companies to avoid creating a PE by using commissionaire arrangements. These, broadly, are arrangements under which an intermediary sells products in a state in its own name but on behalf of a foreign enterprise that owns the products. As the commissionaire is selling in its own name, paragraph 5 is not triggered and the foreign enterprise avoids creating a PE.

The BEPS Report states that such arrangements undermine the policy behind Article 5: "where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing those activities in the course of an independent business".

Currently, paragraph 5 states that a PE will exist where a "person…other than an agent of independent status…is acting on behalf of an enterprise and has, and *habitually exercises…an authority to conclude contracts in the name of the enterprise*" (my emphasis).

This is to be amended so that a PE will now exist where (i) such a person acting on behalf of an enterprise "habitually concludes contracts, or *habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise*", and (ii) the contracts are in the name of the enterprise, *for the transfer of ownership of or the granting of the right to use property owned or used by the enterprise or for the provision of services by the enterprise*.

Removing the need for a contract to be concluded in the name of the enterprise clearly broadens the current test, but the precise meaning of the new wording is far from clear.

The revised commentary identifies the main target, noting that the phrase "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification" will "typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise" and is intended to catch a person acting as the "sales force" of an enterprise. However, one can think of a number of situations in which uncertainty is likely to arise. Will the intermediary be playing "the principal role" if both the principal and the intermediary are involved in the process leading to the conclusion of the contract? Will client-relationship functions which introduce new business to a client be caught by the "principal role" test? And how will the use of standard-form contracts interact with the concept of contracts being "routinely concluded without material modification"?

It seems likely that the revised wording of paragraph 5 will, in the short term at least, lead to disputes with tax authorities as well as increased compliance costs for businesses as they seek to determine what arrangements will be caught.

Overall, while some changes to Article 5 were probably needed, the OECD's implementation of these changes, particularly as regards paragraph 5, is far from perfect.

The Multilateral Instrument

A number of BEPS recommendations – including the Action 7 changes discussed above – will need to be implemented through amendments to double tax treaties. If these changes were implemented on a treaty-by-treaty basis, the high number of treaties involved would make this a slow, administratively burdensome process.

Citing the need for "an efficient and effective mechanism" to implement the tax-treaty-related BEPS recommendations, Action 15 of the BEPS Action Plan called for the development of a "multilateral instrument". The aim is to allow countries to modify existing double tax treaties in a fast and simple way.

As well as Action 7, the multilateral instrument will cover those changes recommended under Action 2 (hybrid mismatch rules), Action 6 (preventing treaty abuse) and Action 14 (effective dispute-resolution mechanisms). The instrument will also include an optional provision on mandatory operation of the "mutual agreement procedure" arbitration as a mechanism that is meant to ensure that treaty-related disputes are resolved in a specified time frame.

Development of the multilateral instrument is currently in progress, with an "Ad Hoc Group" made up of 96 countries, as well as a number of non-state jurisdictions and international organisations, overseeing the process. The Group began its work on 27 May 2015 and is aiming to open the instrument for signature by 31 December 2016.

The UK's Diverted Profits Tax

While the global BEPS project has rumbled on over the last three years, the UK has been busy amending its domestic tax regime so as to target certain types of BEPS behaviour. Chief amongst these changes was the introduction of the DPT on 1 April 2015.

Aiming to "counteract contrived arrangements used by large groups (typically multinational enterprises) that result in the erosion of the UK tax base", the DPT applies, at a rate of 25%, in two situations: where a foreign company makes sales in the UK, but structures its arrangements in such a way that it avoids creating a taxable PE in the UK; and where a company subject to UK tax seeks tax benefits through the use of arrangements which are put in place with connected entities and "lack economic substance". Given its similarity to the BEPS project's Action 7 changes examined above, I would like to focus here on the first situation described above: structures aiming to avoid the creation of a UK PE.

Section 86 of the Finance Act 2015 sets out the rules that target this scenario. A charge to DPT will arise where:

- a person is carrying on an activity in the UK in connection with supplies of goods, services or other property by a company not resident in the UK ("**ForeignCo**") in the course of a trade;
- it is reasonable to assume that any of the activity of the person or ForeignCo, or both, is designed (or deliberately restricted) so as to ensure that ForeignCo does not carry on a trade in the UK for corporation tax purposes; and

- in connection with the supplies made by ForeignCo, either the main purpose of the arrangements is to avoid corporation tax or a tax mismatch is secured such that the total tax derived from UK activities is significantly reduced.

The section 86 charge will not apply where:

- ForeignCo and the avoided PE are both small or medium-sized enterprises;
- annual UK sales do not exceed £10 million; or
- annual UK-related expenses do not exceed £1 million.

Given the obvious similarities to Action 7 of the BEPS project, it may seem strange that the UK decided to bring in the DPT before the OECD had finalised its recommendations. The timing of the DPT is, however, likely to have had more to do with politics than with a well thought-out plan for countering BEPS. It was first announced in the 2014 Autumn Statement, at a time of increasing focus on whether multinationals were paying their "fair share" of tax. The UK government may well have seen the DPT as a chance to take the issue of tax avoidance off the table prior to the 2015 general election.

The government's decision to rush in the DPT in time for the election attracted criticism from both within and outside the UK. Given that Action 7 aims to create a common international definition of a PE, the UK's unilateral introduction of what amounts to a deeming rule in relation to PEs risks endangering any such consensus. Pascal Saint-Amans, director of the OECD's Centre for Tax Policy and Administration, stated in early 2015 that he was "embarrassed" by the UK's decision to introduce the DPT. While expressing "sympathy for the need to move" (and noting the impending "very important electoral date in the UK"), Saint-Amans commented that "unilateral actions are not exactly in the sense of what we are trying to develop" and could "push other countries…to take unilateral measures". Australia has recently brought in its Multinational Anti-Avoidance Law, mirroring the DPT's avoided-PE rule, so these fears were not unfounded.

This fragmentation in what should have been a unified global approach to corporate tax avoidance is concerning not only insofar as it risks undermining the BEPS project but also, specifically as regards Action 7, because it could produce an unfair result. Carol Klein, Vice President of the United States Council for International Business, commented that "unilateral assertions of taxing jurisdiction…increase the likelihood of double taxation". The DPT, Klein explained, "is intended to apply when there is no PE under the relevant rules", and the UK should not be allowed to "disregard agreed-upon rules simply because [it does] not like the outcome".

Klein's conclusion, that the DPT "jumps the gun", is one shared by many in the tax world. Although the US government has not officially condemned the DPT, Robert Stack, Treasury Deputy Assistant Secretary for International Tax Affairs, stated at the 2015 OECD International Tax Conference that the DPT "points in a disturbing direction" and shines a "spotlight on the degree to which political pressure can trump policy".

Extending Royalty Withholding Tax

The UK has now legislated in a second BEPS-related area, making some remarkable changes to the application of royalty withholding tax in the UK.

The UK tax treatment of outbound royalty payments is of course regulated by various international instruments, notably bilateral tax treaties and (for now!) the EU Interest and Royalties Directive; and the UK's tax treaties typically follow the Model Convention, which stipulates that royalties are taxable only in the state of residence of their beneficial owner and thereby helps to remove tax obstacles to cross-border investment and provision of services. Where the source state gives up its right to tax that royalty, however, it does so in the expectation that its treaty partner will be able to tax that royalty.

Revenue authorities complain that multinational groups, especially technology companies, have been exploiting the rules on royalty withholding tax so as to shift profits from high-tax jurisdictions to low-tax jurisdictions. Under such arrangements, IP is held by a group company in a jurisdiction in which little or no tax is paid and no substantive activity takes place. Royalty payments for the use of the IP are routed to the low-tax jurisdiction by judicious use of applicable tax treaties.

The UK changes were first introduced as part of the March 2016 Budget, then fleshed out in a Technical Note published on 27 June 2016. The government summed up its basic complaint as follows: “it is a frustration of the purpose of a tax treaty if a person resident in a third country uses a bilateral tax treaty with the UK to extract tax-free royalties from the UK, especially if no tax is paid on the receipt and no substantive activity is taking place in that third country”.

Thus the new UK rules are said to be aimed at perceived “treaty shopping”. But they could also be seen as a naked tax grab, for reasons I will try to explain below.

There are three main changes, the first two applying to royalty payments made on or after 28 June 2016 and the third to royalty payments made on or after 17 March 2016.

The first change is perhaps understandable, if unwelcome: the range of royalties subject to withholding tax has been significantly widened. Previously, the UK did not withhold tax on royalties to the fullest extent permitted under the treaties. For example, payments for the right to use trade names and trademarks were subject to withholding tax only if they were “annual payments”. An “annual payment” is a payment which is: of an income, rather than capital, nature; payable under a legal obligation; recurrent or capable of recurrence; and “pure income profit” (i.e., the recipient receives the payment without having to do anything in return). Withholding tax now applies to any royalty paid in respect of intangible assets; this is the case whether the royalty payment is pure income profit or is offset against costs.

Second and much more controversially, royalty payments made to a non-resident company doing business in the UK through a PE or “avoided PE” (the new DPT concept) are now deemed to have a UK source – and therefore subject to withholding tax – to the extent that this is “just and reasonable”. Withholding tax is to be applied by apportioning the royalty based on the level of sales through the UK PE as a proportion of the foreign company’s overall sales.

Third, the UK has enacted a treaty override under which royalty payments will not be treaty-protected and will be subject to withholding tax if it is reasonable to conclude that the arrangements in question involve treaty abuse. Specifically, the override is triggered if one of the main purposes of the arrangements is to obtain a treaty benefit and this is contrary to the object and purpose of the treaty. If an entity is interposed, for example between a UK and a Bermuda company, in order to secure treaty protection against UK royalty withholding tax, the override will be triggered and UK withholding tax will apply.

The third change is disappointing for a jurisdiction which has historically been very loath to use domestic legislation to alter unilaterally the effect of bilateral treaties (though the UK did the same when it introduced a GAAR in 2013). But it is the second of these measures, deeming certain royalty payments to have a UK source, that has raised hackles elsewhere.

It is said to be targeted in particular at the so-called “double-Irish structure”. Under such a structure, a UK company may offer sales support to an Irish principal, or act as a “commissionaire” for the principal. The principal then pays royalties to the IP owner, which is based in a territory with which the UK does not have a treaty, such as Bermuda.

Under the previous law, the royalty paid by the Irish principal to the Bermuda company was not paid out of the UK and did not have a UK source. Now, however, that royalty will be deemed to be a royalty payment by the UK company to the extent that it is attributable to activities carried on by the UK company; this attribution will be done on a "just and reasonable" basis.

For many, this is nothing more than extra-territorial taxation. It has been pointed out that the new measure is the equivalent of the New York head office of a bank with a London branch using retail deposits taken in New York to fund the London branch and being treated as though the interest paid on the deposits were UK-source. This would be an absurd result for bank borrowing, and yet it is what is being proposed for royalty payments. A UK distribution company paying full UK tax on the transfer-priced profits generated by its UK activities on behalf of an overseas principal can now be required to account for withholding tax on payments made by an overseas affiliate under agreements which it had no part in negotiating and takes no role in managing.

It appears that what the UK is really trying to tax here are the pools of untaxed profits that sit in low-tax jurisdictions. Many of these pools exist because of the way in which the US tax system operates and, in particular, its controlled foreign company regime ("subpart f"); this makes it relatively easy for a US multinational to avoid US taxation on profits arising in low-tax jurisdictions so long as they are not brought back to the US. It is not obvious why the UK should have the right to tax such profits.

Conclusion

The OECD estimates that global revenue losses from BEPS amount to US$100–240 billion annually, or 4–10% of global corporation tax revenues. It has concluded that unified, transnational reform of the global tax code is needed as a result.

There is of course a real danger of overkill, but at least the BEPS project should produce a common set of rules and the famous "level playing field". It is hard to see how unilateral actions such as the UK's DPT and deemed sourcing rule for royalty withholding tax assist with these objectives.

The BEPS Action Plan warns that "the replacement of the current consensus-based framework by unilateral measures" could lead to "global tax chaos". Such language may be exaggerated, but does point to the risks of the UK – and others – departing from consensus-based reform in favour of idiosyncratic domestic legislation.

Theresa May, the UK's new Prime Minister who is grappling with the consequences of the "Brexit" vote, would do well to heed the words of the G20 leaders from 2012: "Despite the challenges we all face domestically, we have agreed that multilateralism is of even greater importance in the current climate, and remains our best asset to resolve the global economy's difficulties."

This article appeared in the 2017 edition of The International Comparative Legal Guide to: Corporate Tax; published by Global Legal Group Ltd, London.

William Watson
T +44 (0)20 7090 5052
E william.watson@slaughterandmay.com