Current Notes

The diverted profits tax: flawed by design?

Introduction

Since the 2008 financial crisis, the international tax agenda has been dominated by the focus on "stateless income"[1] and "base erosion and profit shifting" (BEPS).[2] Whichever term is used, the essential theme is the same: multinational groups (generally headquartered in the US) are said to employ structures to minimise their tax base in source states, without being subject to US tax on the profits from their non-US business.

A key aim of the BEPS Project has been to address structures of that kind, with Action 6 (treaty abuse), Action 7 (artificial avoidance of permanent establishment status) and Action 8 (intangibles and transfer pricing) all designed with stateless income in mind.[3] It is likely that each of these three Actions will require amendment of tax treaties; however, given the number of tax treaties, the technical and political difficulties of agreeing an approach,[4] the speed of ratification processes, and the fact that the respective final reports will only be completed in September 2015, it is relatively clear that actual implementation will take some time.[5]

It is against this backdrop that the Chancellor of the Exchequer announced at the Conservative Party Conference in September 2014 that a new tax would be introduced, targeting technology companies that "go to extraordinary lengths to pay little or no tax" in the UK.[6] Journalists were briefed that this was a "Google tax" aimed, in particular, at those using the widely-cited "Double Irish" structures to stream income from European subsidiaries into tax haven entities where it can be retained indefinitely without a US Controlled Foreign Company (CFC) charge arising.[7]

In the Autumn Statement, the tax was given a name—the "diverted profits tax" (DPT)—and draft legislation was published for consultation. Final legislation was then published on March 25, 2015, as part of the Finance Bill 2015, with considerable changes in the structure and drafting of the legislation, but relatively few changes of substance. The Finance Bill was enacted five days later without amendment, or indeed any Parliamentary scrutiny, thanks to the compressed pre-election Parliamentary timetable.

[1] See E.D. Kleinbard, "Stateless Income" (2011) 11 *Florida Tax Review* 699, available at: *http://ssrn.com/abstract=1791769* [Accessed April 27, 2015].

[2] OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing, 2013).

[3] OECD, above fn.2, 19.

[4] See, for example, "Plucking the geese", *The Economist*, February 22, 2014.

[5] Action 15, which sets out the mandate for developing a "multilateral instrument" to amend or override tax treaties, suggests that the earliest states could sign up to such an instrument would be 2017—see OECD, *Action 15: A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS* (OECD Publishing, 2015).

[6] G. Osborne, *Speech to Conservative Party Conference 2014*, available at: *http://press.conservatives.com/post/98719492085/george-osborne-speech-to-conservative-party* [Accessed April 27, 2015].

[7] R. Neate, "What is the 'Google tax'?", *Guardian*, September 29, 2014, available at: *http://gu.com/p/422xc/sbl* [Accessed April 27, 2015].

The rationale for the DPT remains unclear. It could therefore have been either to take the sting out of a difficult political issue in light of the upcoming election or alternatively, as some have speculated, in anticipation of a possible partial failure of BEPS.[8] One also cannot underestimate the desire to raise additional tax revenues. The projected yield from the DPT is relatively modest (circa £360 million per year), however it seems from the Red Book that this figure represents only the direct yield from the DPT itself—one would expect there also to be considerable increased corporation tax revenues as businesses restructure to avoid the punitive effect of the DPT.[9]

The DPT's design is in many respects novel. In so far as it can be summarised in one sentence, its overall effect is to test whether offshore arrangements are designed to achieve a particular tax result and, if so, impose tax on the basis that that result is replaced with the arrangement that, hypothetically, would have been entered into if tax had not been a consideration and/or apply an accelerated and punitive 30 per cent up-front transfer pricing adjustment. These key elements seem to the writer to be innovations which are without precedent in the tax codes of other jurisdictions, or in the BEPS materials which have been published to date.

The design of the DPT

Whilst in its broad effect the DPT resembles a corporation tax anti-avoidance rule, it takes a quite different legal form—that of an entirely new and free-standing tax. As one would expect of a tax, as opposed to an anti-avoidance rule, it is formulaic in nature. Given the history of recent UK legislation and case law, it is less than surprising that the formulae in question are complex and multi-faceted (38 pages of legislation and 88 pages of guidance). This complexity has unintended consequences; however, before addressing these, it is instructive to consider those structures which it is likely the DPT is designed to attack, and whether there were other measures that could have been taken instead to attack those structures.

The target

Given the political context, it is reasonable to surmise that an important target of the DPT is technology companies employing variants on the structure presented as "Example 3: Avoiding a UK taxable presence" (Example 3) in the HMRC guidance published shortly after the Finance Act 2015 (FA 2015). This note will focus on that structure.[10]

Example 3 can be summarised as follows (and see Figure 1). A multinational group generates revenue based on valuable intellectual property (IP). The group is headed by a parent company (Company A) which owns the IP for its own territory and holds (directly or indirectly) the other companies in the group. The IP for the rest of the world is owned by another company (Company D) which is established in an EU jurisdiction but resident in a tax haven (and so not itself subject to tax on its income). Company D licenses the IP to Company C, which in turn licenses it to Company B (both being EU resident companies).

[8] See, e.g. S. Picciotto, "The U.K.'s Diverted Profits Tax: An Admission of Defeat or a Pre-Emptive Strike?" [2015] *Tax Notes International* 239.
[9] HM Treasury, *Budget 2015, C 1093, March 2015—Red Book* (2015), p.66 shows the overall yield from the DPT; p.110 shows the projected DPT receipts—the two sets of figures are identical.
[10] HMRC, *Diverted Profits Tax: Interim Guidance* (March 2015), 37.

Company B is the European sales and servicing subsidiary, co-ordinating European activity. There are then subsidiaries in the EU jurisdictions in which the group's customers are based—Companies E, F and G, of which Company E is in the UK. Company E asserts its activities are limited to marketing and support, for which it is remunerated on a cost-plus basis. Its large and well-remunerated staff engage with UK-based customers, and develop close relationships with them, but all sales contracts are finalised online by Company B (not Company E).

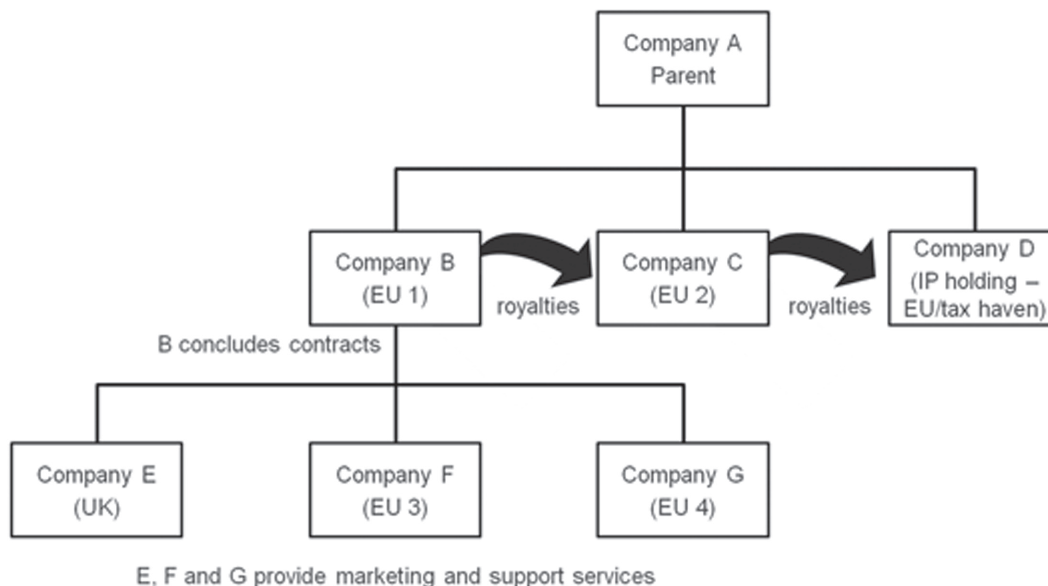

Figure 1: HMRC's "Example 3"

The tax consequences of this are that Company E has UK taxable profits, but these are limited to its (relatively small) taxable margin. Company B has very significant gross revenues, but the terms of its IP licence with Company C require it to pay substantial royalties—hence Company B also has very limited taxable profits. There is no withholding tax on Company B's royalty payments because of a double taxation treaty between the Company B and Company C jurisdictions. Company C also has very limited taxable profits, because it in turn pays almost all of its royalty income out as royalty payments to Company D. There is no withholding tax on Company C's royalty payments because Company C does not impose withholding tax on such payments. As Company D is resident in a tax haven, it pays no tax at all. Unstated but assumed is that Company A is not taxed on Company D's profits under the CFC rules of Company A's jurisdiction (at least until those profits are repatriated back to that jurisdiction).[11]

The road not travelled

Once the political decision was taken to tackle Example 3, HMRC and the UK Government had a number of options which were less ambitious than the DPT.

[11] For which see Kleinbard, above fn.1, 718 in relation to the position of US-headquartered groups.

First, they could have accepted that, economically, the profits "belong" to Company A, and that whether or not Company A's jurisdiction taxes the profits (via a CFC charge or otherwise) were questions for that jurisdiction.

Secondly, they could have attacked the arrangement under existing UK principles. HMRC could have argued that Company B was trading in the UK, and was therefore subject to UK tax, regardless of the fact that contracts had not been concluded in the UK. The place in which contracts are made has not been decisive as a matter of UK tax law for almost a hundred years; the modern test is to determine the location where the operations take place and from which the profits in substance arise.[12] HMRC could have argued that this was the UK. However applying this case law to a modern IP-centred business is not without its difficulties—the case law is generally old, and those cases which have been won by HMRC tend to involve execution offshore, but, materially, all other sales activity being conducted in the UK.[13] By contrast, even on the facts that HMRC presented, there is significant activity carried out by Company B. The writer nevertheless understands that HMRC believe that Company B is carrying on a trade in the UK as a matter of UK domestic law,[14] but sees taxpayers taking the position that this result is overridden by the provision which appears in most of the UK's double taxation treaties that a permanent establishment (PE) will only arise if a UK person has, and habitually exercises, the authority to conclude contracts on behalf of the non-resident.[15] It is curious that HMRC have not sought to test this proposition in the context of the structures they seek to attack, particularly when the 2010 *Commentaries on the Articles of the Model Tax Convention* (*OECD Commentary*)[16] and recent UK tax case law[17] both provide some support for the assertion that a double taxation treaty cannot be used to obtain relief if that gives rise to double non-taxation.[18]

Thirdly, if the litigation risk of challenging the above-mentioned tax treaty argument were thought to be unacceptably high, they could have introduced an explicit treaty override on the point into UK tax legislation. An explicit treaty override would be unprecedented in UK tax law; however it would not seem unduly controversial as a matter of international tax law (given the 2010 *OECD Commentary*) or domestic law (given that the courts have given effect to an implicit treaty override).[19] The litigation risk on the basic "trading in the UK" point would of course remain, although in principle specific anti-avoidance legislation could also be introduced here.

[12] See *F.L. Smidth & Co v F. Greenwood (Surveyor of Taxes)* (1922) 8 TC 193 (HL) at 204.

[13] See *Firestone Tyre & Rubber Co Ltd v Llewellin (Inspector of Taxes)* (1957) 37 TC 111 (HC, CA, HL).

[14] The point was made explicitly by HMRC personnel at the DPT "Open Day" on January 8, 2015, at which the writer was present.

[15] The OECD model actually refers to the authority to conclude contracts "in the name of" the non-resident, but in the context of common law arrangements should be read as "on behalf of" (see J. Avery Jones and D. Ward, "Agents as Permanent Establishments under the OECD Model Tax Convention" [1993] *European Taxation* 155).

[16] See OECD, *Commentaries on the Articles of the Model Tax Convention* (2010), paras 9.4 and 9.5 of the commentary on Art.1.

[17] See the comments of Arden LJ in *Bayfine UK v HMRC* [2011] EWCA Civ 304; [2011] STC 717 at [17].

[18] It might be thought the general anti-abuse rule (GAAR) enacted in FA 2013 could apply to a structure such as this; however the GAAR advisory panel have said that in most cases it will not—see para.B5.2 of *HM Revenue and Customs (HMRC) General Anti Abuse Rule (GAAR) guidance (Approved by the Advisory Panel with effect from 30 January 2015)*, available at: *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/399270/2__HMRC_GAAR_Guidance_Parts_A-C_with_effect_from_30_January_2015_AD_V6.pdf* [Accessed April 27, 2015].

[19] See *Padmore v Inland Revenue Commissioners* [2001] STC 280 (HC).

Fourthly, they could have attacked the problem at the level of Company B or Company C, either by persuading the Governments in question to change their laws or by supporting the European Commission's ongoing state aid investigation into the tax rulings which enable the taxable profits of each company to be so limited.

Fifthly, they could have waited for the outcome of BEPS, in the hope that its implementation would cause Company B to have a UK PE (by virtue of Action 6 or Action 7) and/or that Company B's royalty payment to Company C would become non-deductible (by virtue of Action 8).

It seems safe to assume that the current political environment makes the first option unattractive. One can speculate that the delay and uncertainty inherent in the fourth and fifth options caused them to be discarded. It is less obvious why options two and three were not pursued. The time and risk of litigation is presumably a factor, but it does not explain why, now the DPT has been enacted, HMRC are not (as far as the writer is aware) litigating on the basis of the theories in option two with respect to pre-DPT periods of account (particularly given the near-certainty the DPT itself will be litigated).

The design of the DPT—when the DPT applies

The DPT applies in two distinct cases.

First, where a UK resident company (or UK PE of a foreign company) erodes its tax base by transacting with an affiliate in circumstances where the arrangement or affiliate lacks economic substance, even if the arrangement is at arm's length (the section 80 charge[20]).

Secondly, where a foreign company carries on a business in connection with which there is activity carried on in the UK, but the foreign company's affairs are designed in such a way as to avoid a UK PE arising (the section 86 charge[21]). This is the charge for which Example 3 is the paradigm case. The section 86 charge effectively includes within it the section 80 charge.

Looking at these provisions in more detail, the section 80 charge ("entities or transactions lacking economic substance"[22]) will apply in relation to a company (C) if: there is a "material provision"[23] imposed between C, a company resident in the UK (or a foreign company carrying on a trade through a UK PE) and another person (P) by means of a transaction or a series of transactions; the participation condition is met in relation to C and P (that is, broadly speaking, the parties are connected[24]); the material provision causes an "effective tax mismatch outcome"[25] between C and P which is not an excepted loan relationship outcome; the "insufficient economic substance condition"[26] is met; and C and P are not small or medium sized enterprises. The

[20] FA 2015 ss.80 and 81. For ease of explication, this note refers to the charge on UK residents and UK PEs as the "section 80 charge", notwithstanding that strictly it is FA 2015 s.81 that imposes the DPT on UK PEs of foreign companies.

[21] FA 2015 s.86.

[22] FA 2015 s.80.

[23] FA 2015 s.80(1)(b).

[24] The participation condition is met if, at the relevant time, one of the parties was participating in the management, control or capital of the others or both parties were under common management or control.

[25] FA 2015 s.80(1)(d).

[26] FA 2015 s.80(1)(f).

unfamiliar, and indeed innovative, elements are the "effective tax mismatch outcome[27] and "insufficient economic substance"[28] tests—for which see further below.

The section 86 charge (avoidance of a "UK taxable presence"[29]) will apply where: there is a non-UK resident company (the "foreign company"[30]) carrying on a trade; a person (the "avoided PE"[31]) is carrying on activity in the UK in connection with supplies of services, goods or other property by the foreign company in the course of that trade; it is reasonable to assume that the activity of the avoided PE or the foreign company (or both) is designed to ensure that the foreign company does not carry on that trade in the UK for corporation tax purposes; the "mismatch condition"[32] or the "tax avoidance condition"[33] is met or both of those conditions are met; and the avoided PE is not "excepted."[34]

The tax avoidance condition is the familiar kind of main purpose test, and will be met where there are arrangements in place in connection with the supply of goods, services or property, the main purpose, or one of the main purposes, of which is to avoid or reduce a charge to corporation tax.

The mismatch condition essentially replicates the section 80 charge: that is, there is a "material provision" between the foreign company and another person (here referred to as A)[35]; the "participation condition" is met in relation to the foreign company and A (that is, broadly speaking, the parties are connected)[36]; there is an "effective tax mismatch outcome" resulting from the material provision between the foreign company and A which is not an excepted loan relationship outcome[37]; the insufficient economic substance condition is met[38]; and both the foreign company and A are not small or medium sized enterprises.[39]

The avoided PE is "excepted" if the activity of the avoided PE is such that the foreign company qualifies for one of a number of statutory exemptions from PE.

There is a de minimis exclusion from the section 86 charge if sales related to UK activity by the foreign company and connected persons do not, in aggregate, exceed £10 million, or expenses related to UK activity by the foreign company and connected persons do not, in aggregate, exceed £1 million.

There will be an "effective tax mismatch outcome"[40] where the material provision results in an increase in expenses or deductions or a reduction in income for the first party and the reduction in that party's tax liability is greater than any resulting increase in the second party's total liability to corporation tax, income tax or any non-UK tax. The reduction can be a result of different tax

[27] FA 2015 s.80(1)(d).
[28] FA 2015 s.80(1)(f).
[29] FA 2015 s.86.
[30] FA 2015 s.86(1).
[31] FA 2015 s.86(1)(c).
[32] FA 2015 s.86(1)(f).
[33] FA 2015 s.86(1)(f).
[34] FA 2015 s.86(1)(g).
[35] FA 2015 s.86(2)(a).
[36] FA 2015 s.86(2)(b).
[37] FA 2015 s.86(2)(c) and (d).
[38] FA 2015 s.86(2)(e).
[39] FA 2015 s.86(2)(f).
[40] FA 2015 s.86(2)(d).

rates, availability of a relief, exclusion of any amount from a change to tax or otherwise. This is subject to an "80 per cent test" which provides that there will not be an effective tax mismatch outcome where the amount of tax paid by the second party is at least 80 per cent of the corresponding reduction in the first party's tax liability.

In calculating the reduction in the first party's tax liability, it is assumed that the first party's liability for a relevant tax is tax at the applicable marginal rate on the sum of the expenses/deductions and the reduction in income. It seems that this requires one to look at the gross amount of the expenses/deduction/income, and not at the overall tax consequence for the first party.

The resulting increase in relevant taxes payable by the second party is calculated by reference to the total amount of relevant taxes that would fall to be paid by that second party, assuming that the income equals the first party's total expenses/deductions and reduction in income. Deductions/reliefs relevant to the second party's actual tax liability in respect of the material provisions are taken into account, and it is assumed that any reasonable steps will have been taken to minimise the amount of tax to be paid by the second party. In its original conception in the draft legislation published in December 2014, this test explicitly required one to look at the overall net tax increase of the second party—and in comparing the gross expenses of the first party with the net income of the second, the draftsman created a test that was remarkably easy to fail. That has been remedied, at least partially, by disregarding "qualifying deductions" when determining the increase in tax for the second party—these being, broadly speaking, deductions that do not arise directly from the material provision, and which would have given rise to deductions for the first party had it (and not the second party) made the expenditure.[41] There is, surprisingly, a more generous provision for carried forward losses and group relieved losses of the second party, which are disregarded regardless of their origin and nature.

There are several important exclusions that can prevent an effective tax mismatch outcome from arising. The exclusion for "excepted loan relationship outcomes"[42] applies if the increase in expenses or reduction in income arises wholly from something that would (if a company within the charge to corporation tax were party to it) produce debits or credits under the loan relationships rules and/or (where there is a hedging derivative) the derivative contract rules. The stated intention of this is to exclude financing arrangements from the DPT, and this would seem to have been achieved—a loan by an affiliate should not of itself result in an effective tax mismatch outcome (even if the borrower's effective tax rate is much higher than the lender's); nor should the sale or securitisation of a loan portfolio. The decision to exclude financing arrangements has been subject to criticism[43]; however given the panoply of statutory rules that can deny an interest deduction, and the relative ease of compiling financing comparables from a transfer pricing perspective, the writer would suggest that the decision was a sound one. There are other exclusions where an effective tax mismatch outcome arises solely by reason of payments

[41] See FA 2015 s.108(7); the "qualifying deduction" concept was not included in the original legislation, HMRC, *Diverted Profits Tax* (2015), available at: *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/385741/Diverted_Profits_Tax.pdf* [Accessed April 27, 2015].
[42] FA 2015 s.86(2)(d).
[43] See ActionAid and others, *The Tax Dodging Bill—what it is and why we need it* (2015), available at: *http://taxdodgingbill.org.uk/wp-content/uploads/2014/11/15.01.26-Tax-Dodging-Bill-policy-briefing.pdf* [Accessed April 27, 2015].

to certain classes of person that are exempt from tax or not subject to tax in the usual way: pension schemes, charities, persons who benefit from sovereign immunity, and funds which meet the genuine diversity of ownership condition.[44]

The insufficient economic substance condition will be satisfied if either of the following applies.[45]

First, it is reasonable to assume the transaction or transactions were designed to secure the tax reduction arising from the effective tax mismatch outcome, with a safe harbour where, at the time of making the material provision, it was reasonable to assume that the overall non-tax financial benefits of the transaction would exceed the overall financial benefit of the tax reduction.

Secondly, it is reasonable to assume that the involvement of a person who is a party to the transaction was designed to secure the tax reduction, with safe harbours where, at the time of making the material provision, either it was reasonable to assume that the overall non-tax financial benefits of the transaction referable to the contribution of the person's staff would exceed the overall financial benefit of the tax reduction; or the income attributable to the contribution of that person's staff in an accounting period (excluding holding, maintaining and protecting assets) exceeds other income attributable to the transaction or transactions.

The design of the DPT—how the DPT charge is calculated and applied

The rate of DPT is set at 25 per cent, which is applied to the company's "taxable diverted profits."[46] The taxable diverted profits are arrived at by (very broadly) adding together the hypothetical corporation tax effects of an accelerated transfer pricing computation (in the case of a section 80 charge), attribution of profits to a notional UK PE and the replacement of the material provision with the "relevant alternative provision" (in the case of a section 86 charge).[47]

The relevant alternative provision is the provision which it is just and reasonable to assume would have been made or imposed as between the parties instead of the material provision, had tax (including non-UK tax) on income not been a relevant consideration for any person at any time. Importantly, if the relevant alternative provision would give rise to allowable deductions of the same kind as the actual provision then the "actual provision condition"[48] will be met, and taxable diverted profits are computed on the basis of the actual provision and not the relevant alternative provision. This is the case even if the quantum of deductions would be different (although in such a case taxable diverted profits could still arise as a result of transfer pricing).

It will be apparent that this necessitates the construction of a counter-factual set of arrangements in an artificial commercial world where tax does not exist. This task would be relatively straightforward if evidence were to show that a group migrated from one structure to another solely for tax reasons—presumably the relevant alternative provision is the original structure. Similarly if a new arrangement is entered into solely for tax reasons then presumably the relevant

[44] As defined in reg.75 of the Offshore Funds (Tax) Regulations 2009 (SI 2009/3001), or reg.9A of the Authorised Investment Funds (Tax) Regulations 2006 (SI 2006/964), as applicable.
[45] FA 2015 s.110.
[46] FA 2015 ss.82 and 88.
[47] FA 2015 ss.82–85 and ss.88–91.
[48] FA 2015 s.84.

alternative provision is that there is no arrangement.[49] However in other cases it is easy to see that there could be multiple possible arrangements that could have been entered into and, given one must proceed on the basis that tax on income is not a consideration, those possibilities may include arrangements that no person would ever enter into in reality.

Double taxation is avoided in most (but not all) cases by giving companies credit against DPT when UK corporation tax or foreign tax is paid on the same profits.

The punitive effect of the DPT is magnified by the procedure by which it is imposed. A company is obliged to notify HMRC if the DPT would apply, but with various simplifying modifications and an overriding rule that notification is not required if (broadly speaking) the arrangements have been fully disclosed to HMRC, or it is reasonable for the company to conclude that no DPT charge will arise (ignoring the possibility of future transfer pricing adjustments).[50]

Where a designated HMRC officer determines a company has a DPT liability, he or she will issue the company with a "preliminary notice" with an estimate of the taxable diverted profits. The estimate has to be the "best estimate" that the relevant HMRC officer considers can reasonably be made. However, if there is a "material provision" or "mismatch condition" and the officer considers the material provision provides the company in question with deductions that "might" be greater than they would have been under an arm's length arrangement, then the best estimate is made on the assumption that 30 per cent of those deductions are disregarded (the "inflated expenses" rule).[51]

Following the receipt of the notice, the company has 30 days to make representations. At this stage, the HMRC officer can only consider representations made on certain specified grounds.[52] Having considered any such representations, HMRC must then either issue a charging notice or confirm that no charging notice will be issued. HMRC are obliged to make this determination within 30 days following the expiration of the 30-day period to make representations. If a charging notice is issued then DPT (plus interest) must be paid within 30 days.[53] The taxpayer is free to appeal a DPT "assessment" in the usual way, but this will not delay the obligation to pay the tax. All charging notices are required to be reviewed by HMRC within a year (the review period) and, at this point, all representations previously made by the taxpayer are taken into account. The officer's initial best estimate can then be replaced with the actual result of applying the legislation, and a balancing payment of additional tax or a tax refund made.

Design difficulties

It is the writer's contention that much of the DPT is set on a "hair trigger" and will be satisfied in a great many cases. Furthermore, this is an intentional and necessary feature of the tax without which it might fail to tax those at which it is targeted. Disputes will therefore turn quite quickly

[49] FA 2015 s.82(6).
[50] There is a grace period for accounting periods ending on or before March 31, 2016, for which notification can be within six months of the end of the period.
[51] Disregarded deductions will be reduced if a deduction takes into account a transfer pricing adjustment which is reflected in the tax return prior to the issue of the charging notice and as a result of that such a deduction is less than it would have been.
[52] FA 2015 s.94(3).
[53] FA 2015 s.98.

to whether a charge arises, and central to that will be familiar questions of transfer pricing, and much less familiar questions of what arrangements would have been put in place had tax on income not been a consideration for any person.

The ease of satisfying the DPT conditions—the "hair trigger"

The central element of the section 86 charge is the question of whether activity is designed to ensure a foreign company does not carry on a trade in the UK for corporation tax purposes. The word "activity" expressly includes any limitation imposed or agreed in respect of that activity.[54] The difficulty with this is that many non-UK trading companies will have some activity, temporary or permanent, in the UK. A non-UK manufacturing company may have a marketing or after-sales support affiliate in the UK; even if it does not, it may send personnel to trade shows and conferences in the UK. A non-UK bank looking to attract UK investors for a bond issue it is arranging or underwriting may run "road shows" in the UK. Any non-UK company may have personnel in the UK at conferences or on holiday. Traditionally most practitioners would not take the view that this kind of activity could cause the non-resident to be carrying on a trade in the UK. However most practitioners would still have advised, out of prudence, that care be taken not to sign any documentation in the UK, and that this message be communicated to the personnel "on the ground" or even written into their contracts. This is, however, potentially a "limitation", and one designed to prevent the non-resident carrying on a trade in the UK. Hence the "design" test would seem to be satisfied in the most trivial of cases. Indeed HMRC seem to acknowledge this—the £1 million annual expenses de minimis exclusion is said to have been introduced to help address

> "low risk situations … for example where a group has employees who occasionally come to the UK for business but their costs are relatively small."[55]

It would be attractive to be able to draw a bright line between this sort of case and Example 3, but the DPT legislation does not seem to permit such a line to be drawn, and the writer would speculate that the draftsman of the DPT legislation decided it was safer not to draw a line at all.

One would hope that in the more trivial of cases, the tax avoidance condition would not be satisfied. The HMRC guidance states that HMRC will seek to apply the rule if a company "has put in place arrangements that separate the substance of its activities from where the business is formally done."[56] That approach would seem to prevent an employee secondment (say) falling within section 86—however HMRC's formulation is not reflected in the legislation. Rather, the term "arrangement" is defined to include, inter alia, any agreement or understanding. This creates the unfortunate possibility that the same limitation that trips the "design" test will itself be considered an "arrangement" and therefore, given its sole purpose is the avoidance of tax, the tax avoidance condition will automatically be satisfied. The relevant example in the HMRC

[54] FA 2015 s.86(4).
[55] HMRC, *Summary of amendments following the technical consultation* (updated April 20, 2015), available at: *https://www.gov.uk/government/publications/diverted-profits-tax-guidance/summary-of-amendments-following-the-technical-consultation* [Accessed April 27, 2015], para.21.
[56] HMRC, above fn.10, 18.

guidance seems consistent with such an approach.[57] It is also consistent with the objectives of the DPT—even the most contrived separation of contract execution and pre-contractual negotiations will usually be incidental to the wider commercial purposes of the contract itself, and hence if taxpayers were permitted to read the term "arrangements" to encompass that contract then the ambit of the tax avoidance condition could be very limited. The unsatisfactory conclusion seems to be that the tax avoidance condition is either usually satisfied, or rarely satisfied; given the choice, it is hard to exclude the possibility that a court would prefer the former.

The mismatch condition would also appear to be satisfied in relatively innocuous cases. Naturally, tax-deductible payments to tax haven entities will automatically trigger the mismatch condition, as will payments to Irish companies and other entities in jurisdictions with an effective tax rate of less than 16 per cent. Payments to entities benefiting from special tax regimes (outside the specific exclusions in section 110 FA 2015) will also potentially fail the condition. So, for example, IP licence payments by a UK company to an affiliated UK patent box company will give rise to a mismatch (given that the patent box regime has an effective tax rate of 10 per cent). The "qualifying deduction" rule mentioned above means that payments to intermediaries will not necessarily give rise to a mismatch, but they will do if (for example) the recipient is funded by debt that would not be deductible from a UK tax perspective. Take the sale of (non-loan relationship) assets by a UK bank to an affiliated UK special purpose vehicle (SPV) bond issuer taxed under the UK securitisation company rules.[58] The UK bank will no longer be taxed on its income from the assets and whilst that income will be received by the SPV going forwards, almost all will be used to fund payments by the SPV on its bonds. The SPV will be taxed on (broadly) a cash basis and hence will only pay tax on a small retained margin. The terms of those bonds will in most cases be limited recourse[59] and therefore, on HMRC's usual view, the interest would have been non-deductible had the bonds been issued by the bank. Hence the SPV's financing costs on the bonds are not "qualifying deductions" and the increase in tax payable by the SPV is limited to tax on its margin. The same result will pertain in most cases where the party on the other side of the material provision is funded by limited recourse debt, and it will be appreciated that almost all SPVs are funded in precisely this way.

The "qualifying deduction" rule will also not assist intermediaries who acquire and then immediately sell an income-generating asset. So if, for example, P (resident in the UK) sells an "in the money" derivative to A, and A sells that derivative to B then P will have a reduction in income (as it no longer receives the payments on the derivative); A's increase in tax will be very small, regardless of where it is established (because its taxable profit from the transaction will be limited to a fee or margin). A mismatch therefore arises, even if it turns out that the ultimate owner, B, is resident in the UK and fully taxed on its income from the derivative.

In many cases the analysis will therefore come down to the insufficient economic substance condition. The most plausible escape route for taxpayers will be the "design" tests—that is, to argue that the transaction was not designed, and the involvement of the parties to the transaction

[57] HMRC, above fn.10, 34.
[58] Taxation of Securitisation Companies Regulations 2006 (SI 2006/3296).
[59] "Limited recourse" in the sense that a bondholder is only entitled to receive amounts under the bonds to the extent the SPV can derive a return from its assets; if the assets do not perform then the bondholder has no right to recover from the SPV and no other recourse.

was not designed, to secure the tax reduction from the effective tax mismatch outcome. The difficulty here is that the legislation expressly provides that a transaction, or a person's involvement in a transaction, may be designed to secure a tax reduction despite it also being designed to secure any commercial or other objective.[60] Hence, in contradistinction to the more familiar "main purpose" test, there is no weighing of the tax motivations for an arrangement against the non-tax motivations. It would not be surprising if HMRC's starting point is that, where any transaction involves a tax haven entity, that person's involvement was designed to secure a tax reduction, at least to some extent.

There is surely an implicit de minimis here; mere tax advice to ensure (for example) that payments under an IP licence are tax deductible, or that an SPV qualifies for the UK securitisation taxation regulations, is, it is hoped, not "design". But again, it is difficult to see how the line is drawn, and the writer would speculate that the absence of a clear line is a deliberate drafting choice by HMRC to ensure that arrangements such as Example 3 (and more subtle variants thereof) are caught by the DPT, even though there will be many non-tax motivations behind the structure.

Once the "design" tests are failed then the taxpayer has to fall back on the safe harbours.

Where a transaction has an immediate financial benefit then it may be straightforward to show that, at inception, it was reasonable to assume that the overall non-tax financial benefits of the transaction would exceed the overall financial benefit of the tax reduction. However transactions are often entered into for reasons that are not so readily quantifiable; perhaps to develop future business; perhaps for regulatory capital reasons; perhaps to rationalise a historic and unwieldy group structure. In such cases, the safe harbour may be difficult to access.

More difficult still are cases where it can be said that a person's involvement in a transaction was designed to secure the tax reduction. The safe harbour here narrows the test in the previous paragraph to measure only non-tax financial benefits referable to the contribution of the person's staff. This is problematic for several reasons. First, many arrangements to which the DPT will apply are essentially passive in nature, and the non-tax financial benefits will arise from the transaction itself rather than from ongoing activity of personnel. Secondly, where the "person" concerned is an SPV, holding company or similar vehicle, it may well have no staff. Thirdly, even where personnel are actively involved in the person's affairs, the individuals concerned may be employees of another entity which has contracted with the person (as an asset manager, for example)—however it appears such individuals will not be "staff" for this purpose.[61]

It may be helpful to summarise two paradigm cases of the DPT's unintended consequences.

A German widget manufacturer has a UK affiliate conducting marketing activity, but which is forbidden from negotiating or contracting with customers. There is a significant risk that the "designed to avoid a PE" test is satisfied. If so, that alone may be sufficient for the tax avoidance condition to be satisfied, in which case the section 86 DPT charge will apply. If the German manufacturer's profits are subject to material deductions for IP royalties paid to an Irish affiliate then there will be an effective tax mismatch outcome; if the Irish affiliate is passive in nature

[60] FA 2015 s.110(9)(b).

[61] As FA 2015 ss.110(8)(c) and 110(10) refer to the "externally provided worker" definition in CTA 2009 s.1128, which will not generally be satisfied in a typical investment management or asset management arrangement (although it may be satisfied where staff are seconded intra-group).

then the insufficient economic substance condition may be satisfied. The DPT charge will then apply even if the tax avoidance condition is not satisfied.

A UK pharmaceutical company develops valuable IP and sells it to an affiliated UK SPV which licenses it back. The SPV qualifies for the UK patent box regime and a tax mismatch therefore arises (as is indeed the intention of the patent box rules). The sole purpose of the involvement of the SPV was to gain that mismatch, and the SPV has no staff so the insufficient economic substance condition is satisfied. The section 80 DPT charge therefore applies, with the curious outcome that the pharmaceutical company is penalised for using the patent box regime precisely as intended by the Government.

The difficulty of applying the DPT charge

It is clear that HMRC believe that Example 3 is caught by the section 86 charge. However it is less clear that material tax actually results.

For the purposes of section 86, Company E would be the "avoided PE" and Company B would be the "foreign company." Let us assume for the purposes of exposition that the conditions in section 86(1)(a) to (d) and (h) FA 2015 are met and note that the exception referenced at section 86(1)(g) FA 2015 would not apply. On this basis, in order to achieve a successful charge, HMRC would first have to show that it is reasonable to assume that any of the activities of Company E or Company B are designed to ensure that Company B does not, as a result of Company E's activity, carry on a trade in the UK. For the reasons discussed above, that does not seem particularly challenging. Given that Company D is resident in a tax haven, the mismatch condition is straightforwardly met. The tax avoidance condition is likely to be satisfied as well (subject to arguments around what precisely the "arrangements" are, but the point is moot). All that is left is for HMRC to show that the "insufficient economic substance condition" is met. Here, HMRC can focus on either Company C (inserted to gain access to the tax treaty) or Company D (established in a tax haven). On the facts, neither has staff making a material financial contribution, and hence the condition is met.

Given the centrality of IP to the group's business, HMRC concede in the guidance that the actual provision condition will be met, because Company B would always have licensed the IP from a non-UK entity.[62] Given the quantum of the royalty payments paid by Company B, it can be assumed that merely taxing a notional UK PE of the company will yield little in the way of DPT revenues. To achieve a better result, HMRC have to apply the transfer pricing rules to deny a material proportion of Company B's royalty payments. That is straightforward in the short term—one assumes the HMRC officer will readily conclude that the royalty payments "might" be greater than they would be under an arm's length arrangement and therefore his or her estimate will immediately calculate DPT liability based on a 30 per cent reduction in royalty payments. However assessing the final result is much more difficult. A discussion of the transfer pricing analysis of such an arrangement is outside the scope of this note, but suffice it to say that the group will likely argue that essentially all of its value derives from the IP, that the value provided by Company B's personnel is limited, that the terms of the royalty are such that Company B takes no risk, and that under the circumstances the royalty payments are on arm's length terms.

[62] HMRC, above fn.10, 38.

Hence one would expect the extent of the DPT charge to be fiercely contested, albeit with HMRC having the considerable advantage of the 30 per cent "inflated expenses" up-front payment (which the HMRC guidance suggests will be used as an aide to transfer pricing negotiations).[63]

One is left with the uncomfortable impression that the ease of application of the DPT, thanks to the "hair trigger", and the harshness of the procedural rules, is more significant to Company D than the actual DPT that can technically be collected. The only comfort for the two "innocent" paradigm cases may be that HMRC are unlikely in practice to seek to apply the DPT to them.

Potential legal challenge

Given the complexity of the DPT legislation; the breadth of arrangements potentially within the scope of the DPT charge; and the costs and disruption involved in restructuring existing business arrangements to avoid such a charge, it appears inevitable that at least some taxpayers will look to potential avenues to challenge the DPT.

Compatibility with EU law—whether there is a restriction on a fundamental freedom

Although it is settled that direct taxation falls within the competence of the Member States, it is also well-established that they must exercise that competence in accordance with the laws of the EU.[64] Accordingly, where a tax measure of a Member State restricts or hinders the exercise of a freedom guaranteed in the Treaty on the Functioning of the European Union (TFEU), the measure is prima facie unlawful, unless it can be justified by an objective permitted in EU law and is also proportionate in relation to that objective.

The freedom of establishment is perhaps the most likely TFEU freedom to be restricted by the DPT. Article 49 TFEU provides that

> "restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited."[65]

This freedom involves the right of nationals of a Member State to take up and pursue activities, and set up and manage undertakings in another Member State, under the conditions laid down by the law of the Member State of establishment for its own nationals. Moreover, the freedom also prohibits the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation.

One clear result of the enactment of the DPT is that non-UK companies incorporated in another Member State could carry out trading activities in the UK which are taxed at a higher rate (25 per cent) than a UK entity would be taxed at if it carried out the same activities (presumably 20 per cent corporation tax). However, the differences in treatment extend beyond the rate of tax; DPT is payable on an accelerated timescale on the basis of estimates and deeming rules applied at HMRC's discretion, and which the taxpayer has little opportunity to challenge; other reliefs

[63] HMRC, above fn.10, 40.

[64] See, e.g. *Santander Asset Management SGIIC SA v Directeur des residents a l'etranger et des services generaux* (Joined Cases C-338/11 to C-347/11) [2012] 3 CMLR 12; [2012] STC 1784 (ECJ) at [14] and the case law cited therein.

[65] Consolidated version of the Treaty on the Functioning of the European Union [2012] OJ C326/01 Art.49.

such as group, consortium and loss reliefs are unavailable; and the taxpayer must pay in full before any appeal in relation to the DPT charge is heard. Both the rate and the design of the DPT therefore contrast harshly with the usual rules for the taxation of UK companies and companies trading via a PE in the UK. Accordingly, it seems strongly arguable that the German widget maker discussed above would suffer discriminatory treatment, hindering its ability to exercise its freedom of establishment.

Depending on the nature of the arrangements entered into by the taxpayer, the free movement of capital may also be engaged by the DPT. Article 63 TFEU provides that "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited."[66] In the absence of a definition of what constitutes a "movement of capital" in the TFEU, the Court of Justice of the European Union (CJEU) held in *Trummer and Mayer*[67] that its meaning should be determined by reference to the nomenclature in Annex I to Council Directive 88/361/EEC.[68] The nomenclature covers a wide variety of arrangements, although it is not exhaustive; the significance is that the "material provision" which can trigger the application of the section 80 or the section 86 charge may well be a "movement of capital" for this purpose.

Other TFEU freedoms may be engaged, depending on the nature of the taxpayer's business. For example, Article 56 TFEU provides that

> "restrictions on freedom to provide services within the Union shall be prohibited in respect of nationals of Member States who are established in a Member State other than that of the person for whom the services are intended."[69]

This freedom may be relevant in relation to a number of the technology companies which the Government intends to fall within the scope of the DPT, particularly given the recent judgment in *Commission v France*,[70] in which the CJEU held that "the supply of electronic books is an electronically supplied service"[71] for VAT purposes.

It should be noted that, whilst the freedom of establishment and free movements of goods and services are only engaged where the parties concerned are established in Member States, there is no prohibition on parties outside the EU obtaining indirect benefit from these fundamental freedoms. So, for example, if Company A in Example 3 is established in the US then that is no bar to Company B making a claim based on its freedom to provide services to the UK.[72]

Compatibility with EU law—whether a restriction can be justified

It will be appreciated that successfully establishing that the DPT restricts a TFEU freedom does not of itself render the DPT unlawful as a matter of EU law. Once a restriction is established,

[66] TFEU, above fn.65, Art.63.1.
[67] *Trummer and Mayer's Application to Register Land, Re* (C-222/97) [1999] ECR I-1661 (ECJ) at [7].
[68] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.
[69] TFEU, above fn.65, Art.56.
[70] *Commission v France* (C-479/13) [2015] BVC 14 (ECJ).
[71] *Commission v France*, above fn.70, [2015] BVC 14 (ECJ) at [34].
[72] These were essentially the facts in *Halliburton Services BV v Staatssecretaris van Financiën* (C-1/93) [1994] ECR I-1137 (ECJ) although the question of whether a third country resident could indirectly was not discussed in the judgment; see further discussion in T. O'Shea, "Accessing EU 'tax advantages'" [2009] *International Tax Report* 6.

the determinative factors are whether such a restriction is justified by an overriding reason of public interest and whether such a restriction is proportionate to the objective sought.

Readers will no doubt be familiar with the judgment of the CJEU in *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC* (*Cadbury Schweppes*), in which it was held that

> "a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned."[73]

The Court held further that in order for a restriction to be justified on the ground of prevention of abusive practices

> "the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory."[74]

The CJEU has tended to consider whether a measure is justified in much the same way regardless of the TFEU freedom at issue. For example, in the free movement of capital context, in *Itelcar—Automóveis de Aluguer Lda v Fazenda Pública* (*Itelcar*)[75] the CJEU restated the "wholly artificial arrangements" threshold, finding that in order to be justified a restriction must be one which

> "specifically targets wholly artificial arrangements which do not reflect economic reality and the sole purpose of which is to avoid the tax normally payable on the profits generated by activities carried out on the national territory."[76]

It follows from the difficulties identified above that the DPT is not specifically targeted at wholly artificial arrangements. In principle it would seem to apply to a variety of commercial arrangements with a tax element, even if that element is incidental, and even if non-tax financial benefits are very substantial (as an arrangement which has a £49 million non-tax financial benefit and a £51 million tax benefit will potentially fail the insufficient economic substance test). Nor does such a comparison say anything about whether the transaction is wholly artificial; arrangements may be genuine with a very significant tax benefit, just as arrangements may be artificial with no tax benefit. Assessments under the DPT legislation of whether arrangements have a tax motivation or generate a significant tax benefit are directed at the wrong questions; and are no substitute or surrogate for the requirement that restrictions specifically relate only to wholly artificial arrangements. This was emphasised in *Fred. Olsen and Others and Petter Olsen and Others and The Norwegian State* (*Fred Olsen*), in which the European Free Trade Association (EFTA) Court held that

[73] *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC* (C-196/04) [2006] ECR I-7995; [2006] STC 1908 (ECJ) at [51].
[74] *Cadbury Schweppes* (C-196/04), above fn.73, [2006] STC 1908 (ECJ) at [55].
[75] *Itelcar—Automóveis de Aluguer Lda v Fazenda Pública* (C-282/12) [2013] BTC 681 (ECJ).
[76] *Itelcar* (C-282/12), above fn.75, [2013] BTC 681 (ECJ) at [34].

> "what is decisive is the fact that the activity, from an objective perspective, has no other reasonable explanation but to secure a tax advantage."[77]

However one views the activity of Company B in Example 3, it is not "wholly artificial"—it employs real staff, in real premises, and engages in actual profit-making activity.

In this context the taxpayer is in the somewhat unusual position of having a good sense of what HMRC's arguments are. Their view is that the DPT is lawful because it is "directed against arrangements that are abusive or contrived and designed to erode the UK tax base."[78] The problem with this is that "abusive", "contrived" and "designed to erode" are not tests founded in EU law. In answer to this, the Government appears to rely on the position set out in its June 2011 Consultation Document on reforming the UK's CFC rules,[79] in which it proposed that a new "general purpose exemption" would be introduced, directed at whether there had been an artificial diversion of profits from the UK, rather than whether genuine economic activities had been conducted in another Member State. The Government set out its understanding that cases such as *Cadbury Schweppes*[80] and transfer pricing cases such as *Test Claimants in the Thin Cap Group Litigation v HMRC* (*Thin Cap GLO*)[81] and *Société de Gestion Industrielle SA (SGI) v Belgian State* (*SGI*)[82] constitute one body of anti-tax avoidance case law. The basis on which they formed this view is not clear, but what is clear is that the European courts have declined to adopt the Government's formulation. The "wholly artificial" threshold was recently reaffirmed in *Inspecteur van de Belastingdienst/Noord/kantoor Groningen v SCA Group Holding BV*[83] and *Fred Olsen*,[84] in which the CJEU and the EFTA Court (respectively) specifically cited the language used in *Cadbury Schweppes*[85] without reference to any wider body of EU anti-tax avoidance jurisprudence. In the absence of specific contrary authority from the CJEU, the test therefore remains that set out in *Cadbury Schweppes*.[86] The DPT clearly brings a much wider class of arrangements within the charge and, crucially, there is no express exemption for companies actually established in other Member States and carrying on genuine economic activities there. Nor do the various conditions and thresholds included in the legislation create an effective exemption for such companies.

However, even taking HMRC's arguments at their highest and assuming that the restriction is justified by the need to tackle abusive or contrived arrangements which erode the UK tax base and that that is the appropriate test, and the DPT is applied only to such cases, the DPT still faces the considerable challenge of establishing that it is proportionate to its objective. In order for a

[77] *Fred. Olsen and Others and Petter Olsen and Others and The Norwegian State* (Joined Cases E-3/13 and E-20/13) [2015] OJ C68/5.
[78] Slides prepared by HMRC for discussion at Open Day, January 8, 2015, above fn.14, available at: *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/400340/Diverted_Profits_Tax.pdf* [Accessed April 28, 2015].
[79] HM Treasury and HMRC, *Controlled Foreign Company (CFC) reform: response to consultation* (December 2011).
[80] *Cadbury Schweppes* (C-196/04), above fn.73, [2006] STC 1908 (ECJ).
[81] *Test Claimants in the Thin Cap Group Litigation v HMRC* [2011] EWCA Civ 127; [2011] STC 738.
[82] *Société de Gestion Industrielle SA (SGI) v Belgian State* (C-311/08) [2010] ECR I-487 (ECJ).
[83] *Inspecteur van de Belastingdienst/Noord/kantoor Groningen v SCA Group Holding BV* (C-39/13) [2014] STC 2107 (ECJ).
[84] *Fred Olsen* (Joined Cases E-3/13 and E-20/13), above fn.77, [2015] OJ C68/5.
[85] *Cadbury Schweppes* (C-196/04), above fn.73, [2006] STC 1908 (ECJ).
[86] *Cadbury Schweppes* (C-196/04), above fn.73, [2006] STC 1908 (ECJ).

restriction to be justified, it has to be narrowly tailored so that it goes no further than necessary to achieve its objective. The DPT is not specifically targeted at "letter box" or "brass plate" entities which do not reflect economic reality; and many instances which may fall within the DPT charge will be those in which the legal arrangements reflect "economic reality in the State of establishment that can be certified on the basis of objective and verifiable elements."[87] Furthermore, the uncertainty of interpretation of the "design" tests and the "relevant alternative provision" concept is at variance with the principle in cases such as *Itelcar*[88] and *Société d'investissement pour l'agriculture tropicale SA (SIAT) v Belgium*[89] that, in order for a measure to be justified, it must comply with the principle of legal certainty. Rules of law must be clear, precise and predictable as regards their effects, in particular where they may have unfavourable consequences for individuals and undertakings. Finally, the lack of opportunity afforded to the taxpayer to show that its arrangements are genuine and correspond to economic reality may itself be a bar to a defence of justification.[90]

In summary, the DPT appears to have a number of vulnerabilities under EU law as TFEU freedoms, including the freedom of establishment, the free movement of capital and the freedom to provide services, are likely to be engaged. In determining whether restrictions on such freedoms are justified the Government's arguments as to the state of European jurisprudence are unconvincing and fly in the face of consistent CJEU and EFTA Court case law. Absent a radical departure from that case law, it is doubtful the DPT would survive EU law challenge.

Compatibility with the UK's double tax treaties

It has been suggested by some commentators that the UK's network of double tax treaties may provide taxpayers with an argument to challenge the DPT. The Government appears to have two substantive arguments in this regard. Their first is that the DPT is simply not covered by double tax treaties as it is a new tax and is not "substantially similar" to an existing tax, such as corporation tax, which is covered under the treaties. Their second argument is that the arrangements targeted under the DPT are abusive and that as such, benefits under double tax treaties do not have to be afforded to such arrangements, in line with paragraph 9.4 of the *Commentary to Article 1 of the OECD Model Tax Convention*.[91]

Each of these substantive arguments is open to considerable doubt. However, even if a taxpayer is able to establish that the DPT breaches the provisions of a double tax treaty, it is likely to be met with an insurmountable hurdle in domestic UK tax law. The High Court stated in *NEC Semi-Conductors Ltd v HMRC* (*Boake Allen*)[92] that:

> "If a resident company wishes to be able to rely on an infringement of the agreement in direct proceedings against the Inland Revenue, it also needs to establish that the particular effect of the agreement has been incorporated into United Kingdom domestic law. If it has

[87] *Fred Olsen* (Joined Cases E-3/13 and E-20/13), above fn.77, [2015] OJ C68/5 at [176].
[88] *Itelcar* (C-282/12), above fn.75, [2013] BTC 681 (ECJ).
[89] *Société d'investissement pour l'agriculture tropicale SA (SIAT) v Belgium* (C-318/10) [2012] STC 1988; [2012] 3 CMLR 35 (ECJ).
[90] *Fred Olsen* (Joined Cases E-3/13 and E-20/13), above fn.77, [2015] OJ C68/5 at [181].
[91] OECD, *Commentaries on the Articles of the Model Tax Convention*, above fn.16.
[92] *NEC Semi-Conductors Ltd v HMRC* [2003] EWHC 2813 (Ch); [2004] STC 489.

> not been so incorporated, then the actions of the Inland Revenue in operating the tax system in a way which conflicts with the agreement may be a breach of international law between the United Kingdom and the other State. But that does not give to the aggrieved taxpayer rights for which it can claim protection in the national courts of this country."[93]

This was subsequently upheld in the Court of Appeal[94] and House of Lords.[95]

Treaties are not "self-executing" in UK law and so, although they bind the UK and the Contracting State in international law, they do not take automatic effect in UK domestic law until implemented. Section 6 of the Taxation (International and Other Provisions) Act 2010, for instance, gives effect to the double tax treaties entered into by the UK as regards income tax, corporation tax, capital gains tax and petroleum revenue tax. However, there is no equivalent in respect of the DPT (and it seems almost certain none will be introduced).

In the absence of such a provision, a taxpayer will have no direct means to challenge the DPT on the grounds that it breaches a double tax treaty entered into by the UK. It may be possible for a taxpayer to indirectly challenge the DPT under the mutual agreement procedure provisions of the relevant double tax treaty if it is able to persuade the competent tax authority of its state of residence (either after presenting its case to the authority or by bringing judicial review proceedings or similar) that its objection under the treaty is justified and that the state is able to resolve the case with HMRC by mutual agreement. However, given HMRC's apparent view that the DPT is in line with the UK Government's obligations under its network of double tax treaties, this seems remote.

Compatibility with human rights law

Other commentators have suggested that the DPT's penal rate, the limited grounds for taxpayers to dispute initial assessments and the requirement for the tax to be paid up front, mean that the DPT is contrary to Article 6 of the European Convention on Human Rights (the Convention) (which protects the right to a fair trial), as implemented in UK domestic law via the Human Rights Act 1998. However, previous attempts by taxpayers to assert human rights arguments in UK tax cases have been largely unsuccessful. This is a consequence of the European Court of Human Rights' (ECtHR) repeated refusals to accept that tax disputes fall within the ambit of the Convention.

In *Ferrazzini v Italy* (*Ferrazzini*),[96] the ECtHR made clear that it considers tax disputes to be "outside the scope of civil rights and obligations", making it very difficult to argue a breach of Article 6 successfully in tax matters. The Court also highlighted Article 1 Protocol 1 of the Convention which is clear that States have the right to enact such laws as are deemed necessary to secure the payment of tax. A claim for a breach of human rights due to the DPT would therefore be tenuous at best. This is underlined by ECtHR judgments such as *A v Sweden*[97] and *Gasus Dosier- und Fördertechnik GmbH v Netherlands*,[98] in which it was held that States have a wide

[93] *Boake Allen*, above fn.92, [2004] STC 489 at [35].
[94] *Boake Allen Ltd v HMRC* [2006] EWCA Civ 25; [2006] STC 606.
[95] *Boake Allen Ltd v HMRC* [2007] UKHL 25; [2007] STC 1265.
[96] *Ferrazzini v Italy* (44759/98) [2001] STC 1314 (ECtHR).
[97] *A v Sweden* (11036/84) (1987) 9 EHRR CD127.
[98] *Gasus Dosier- und Fördertechnik GmbH v Netherlands* (A/306-B) (1995) 20 EHRR 403 (ECtHR).

margin of appreciation in making tax claims, which can only be challenged where the legislature's assessment was "devoid of reasonable foundation." This is an exceptionally high bar. A challenge under Article 6 would not only have to contend with the general disinclination of the ECtHR to find that tax issues are within its scope but also its near-insurmountable bias towards States in the determination of tax matters.

In the UK, the courts have shown a general willingness to adopt the same approach and, as such, a general unwillingness to find tax measures contrary to human rights legislation. A number of English cases have indeed cited *Ferrazzini*[99] in rejecting tax human rights claims, including *New Fashions (London) Ltd v HMRC*.[100] A number of others have adopted similar approaches; for example, in *R. (on the application of Professional Contractors Group Ltd) v IRC* (*Professional Contractors Group*),[101] a human rights challenge was rejected on the basis that the measure did not amount to a "de facto confiscation … fundamental interference with his financial position or … an abuse of the UK's right to levy taxes."[102]

Accordingly, a human rights-based challenge to the DPT is unlikely to be fruitful. The DPT may be disproportionate and bring genuine commercial arrangements within its scope, but the wide margin of appreciation afforded to States by the ECtHR and the UK courts means a human rights argument is bound to fail.

Conclusion

The writer expects that HMRC will apply the DPT to the high profile structures it was designed to counter (if the businesses concerned do not restructure their affairs), although ultimately their success is far from assured on transfer pricing grounds, and doubtful once EU law is brought to bear. Conversely, the writer does not expect HMRC to seek to apply the DPT to any of the ordinary commercial scenarios identified in this note—although as a technical matter they are very possibly subject to the tax. It is, however, deeply unsatisfactory for taxpayers and practitioners if an entire tax is based around the principle of being taxed by law and untaxed by concession. It may well be that the CJEU eventually gives HMRC and the Government cause to find that approach equally unsatisfactory.

Dan Neidle*

[99] *Ferrazzini* (44759/98), above fn.96, [2001] STC 1314 (ECtHR).
[100] *New Fashions (London) Ltd v HMRC* [2005] EWHC 1628 (Ch); [2006] STC 175.
[101] *R. (on the application of Professional Contractors Group Ltd) v IRC* [2001] EWHC Admin 236; [2001] STC 629.
[102] *Professional Contractors Group*, above fn.101, [2001] STC 629 at [43].

Base erosion and profit shifting; Corporation tax; Diverted profits tax; Double taxation treaties; EU law; Human rights; Justification; Multinational companies; Proportionality; Tax avoidance
* Partner, Clifford Chance LLP. The writer would like to thank Jemma Dick, Asta Evans, Rob Sharpe and Rob Taylor for their assistance in the preparation of this note.