Diverted profits tax: a partial response

There are many interesting points made in Dan Neidle's note on the diverted profits tax (DPT).[1] This writer would like to take the opportunity to express a different view on one of the rather important points he makes in his note.

This writer agrees entirely with Neidle that a challenge to the DPT before the UK domestic courts based on compatibility with the UK's double tax treaties would not be successful; similarly, this writer agrees that a claim based upon compatibility with human rights law would be bound to fail. Where this writer disagrees is with the conclusion that it is doubtful that the DPT would survive an EU law challenge. Whilst entirely accepting that, at the current state of development of EU direct tax law, it is impossible to be categorical as to the impact it may have, this writer believes that there are other aspects of EU law that need to be taken into consideration and, when these are considered, it is more likely that the DPT would survive a challenge based upon EU law, if one were brought.

It is necessary to bear in mind as a starting point that, as Neidle himself admits, the DPT is targeted at contrived and artificial tax structures employed by multinational groups. The legislation targets the same artificial arrangements that are part of the focus of the current base erosion and profit shifting (BEPS) Project of the G20 and OECD. By the time that any challenge comes before the European Court, what the DPT seeks to achieve may be commonplace amongst other European countries.

In considering which of the fundamental freedoms might be applicable, Neidle suggests that the free movement of capital might be relevant. In the view of the writer, this is extremely unlikely. The legislation is concerned with arrangements between companies under common control, or with the avoidance of establishing a permanent establishment (PE) in the UK. Where there is a dominant influence, it is clear that the appropriate freedom to consider is the freedom of establishment. Not only does the legislation target controlled relationships, but factually it is concerned only with groups where there is common control. Any impact on the free movement of capital would be purely incidental, and would not merit a separate consideration. This is significant, of course, because the freedom of establishment is restricted to intra-EU situations.

It is possible that the freedom to supply and receive services might be engaged; for example, where there is a royalty charge for the use of intellectual property by a company in another state. However, that is also limited to intra-EU situations and is unlikely to produce a different result from the freedom of establishment.

So far as any interference with the enjoyment of the freedom of establishment is concerned, Neidle's reasoning is somewhat puzzling. He suggests that cross-border arrangements that have been designed to achieve a tax mismatch outcome or to avoid a PE would be disadvantaged by comparison with wholly domestic situations where the companies could pay corporation tax at the current 20 per cent rate in accordance with the normal legislation applicable. However, that misses the point: had the cross-border arrangements not been designed to avoid a PE or to exploit a tax mismatch outcome, the profits would have been subject to corporation tax at the normal

[1] D. Neidle, "The diverted profits tax: flawed by design?" [2015] BTR 147.

rate and under the normal legislation. It is always open to the group concerned to dismantle their artificial arrangements and to pay corporation tax, and it is expected that many of the groups will do so. As Neidle quite correctly points out, the estimate for the revenue from DPT does not take into account the potential increase in corporation tax from the protection of the corporation tax base that the DPT affords. In effect, what Neidle is complaining of is that the multinational groups concerned cannot continue to employ their artificial arrangements to avoid paying corporation tax on profits arising in the UK. The fundamental freedoms are freedoms to establish oneself in another member country for genuine commercial purposes, or to supply and receive services for genuine purposes: they are not a freedom to continue artificially avoiding the tax normally due on profits arising in the UK.

As Neidle correctly points out in his note, most of the groups who are likely to be impacted by the DPT are groups based in the US: from a purely merits position, it would be a little surprising if a US based group (taking advantage of the dysfunctional nature of the US taxation of international income) sought to rely upon EU law to allow them to continue to operate artificial arrangements which, by definition, were designed either to avoid a PE or to achieve a tax mismatch outcome, and to expect the European Court to back them up in this endeavour.

One more point on the freedom of establishment. Though the issue is the freedom of a company established in another Member State to exercise its freedom to establish itself in the UK, issues of the substance and role of the non-UK companies in the structure would also be relevant. In many cases targeted by the legislation, the company outside the UK that is the recipient of a base-eroding payment or that is seeking to avoid a PE would lack any substance in the other Member State where it is incorporated or resident. In many cases, the entitlement of those substanceless overseas companies to rely on the freedoms would be at issue even before they started to raise any interference with the freedom of establishment in the UK.

Justification

Assuming for a moment that the multinational group seeking to challenge the DPT could validly rely upon the freedom of establishment and could show that the DPT restricted the enjoyment of that freedom (just to emphasise, this is a hypothetical situation: as explained above, it is by no means clear that a multinational group would be able to raise this or any freedom). The issue then arises of possible justification: Neidle has considered only the possible justification based upon combating tax avoidance, and its somewhat classical formulation as legislation targeted at "wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned".[2] As we shall see, this may not be the only possible justification (see discussion below).

Consideration of the "wholly artificial arrangements" formulation requires not just a consideration of what the European Court has said in the past, but where the jurisprudence in this area is heading. Whatever "wholly artificial arrangements" means, it clearly does not mean *wholly artificial arrangements*: given a literal interpretation, this would restrict the scope of

[2] *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC* (C-196/04) [2006] ECR I-7995; [2006] STC 1908 (ECJ) at [51].

anti-avoidance legislation effectively to sham arrangements. The European Court has more recently talked about arrangements that are wholly or partly artificial.[3]

Two points on the current formulation. First, it is the arrangements that have to be wholly artificial (whatever that means): there may be a commercial activity, but if arrangements are inserted that are wholly artificial and that have no purpose other than the avoidance of tax, then the justification will be satisfied. Secondly, it is by no means conceded that the DPT legislation has not been drafted so that it targets precisely arrangements that are wholly artificial: the requirements of a tax mismatch outcome, or of a tax avoidance purpose, could satisfy the classical test.

It is reasonable to assume that the members of the European Court are aware that there is an element of disquiet, most notably among Member States, that the "wholly artificial arrangements" test is simply too narrow to allow governments the appropriate scope to combat avoidance activities. References to wholly or partly artificial arrangements, and to the possibility of two or more justifications combined, reflects the fact that the members of the Court are aware that the current formulation is too constricting. Neidle's approach is a static one, assuming that the European Court has reached a final position on the justification of combating tax avoidance. However, EU tax law is evolving, and the correct approach is a dynamic one which recognises that the Court may reinterpret this phraseology, even if it does not change the wording that it uses. If the Court were minded to develop the justification of combating tax avoidance (as a stand-alone justification) in the direction of combating base erosion structures that are internationally recognised as abusive, the case of the DPT (if it were ever brought before the European Court) would give them a good opportunity to do so.

Neidle's note only considers this one justification. However, there are other possible justifications that could be raised, and the category of justifications is not closed. First, the European Court has from time to time recognised that a measure that is restrictive of a fundamental freedom may be justified on the grounds of two or more justifications combined. The first time in a tax context that the Court did this was in *Marks & Spencer plc v Halsey*,[4] where a measure could be justified by three separate justifications taken together. In that case, one of the justifications was combating tax avoidance, but it was clear that the Court understood tax avoidance in this context as having some meaning other than combating wholly artificial arrangements (otherwise, why would it have been necessary to combine justifications). In the DPT case, the two most obvious justifications to combine would be combating tax avoidance and the principle of territoriality: this is the principle that profits arising in a territory may be taxable there. By the DPT, the UK seeks to ensure that profits arising in the UK are taxable here, and that artificial arrangements to avoid that tax are suitably combated.

Secondly, there may be new justifications that develop. By the time any case relating to the DPT comes to court, the BEPS Project will have run its course. The Court may come to recognise that measures that are consistent with the international approach to combat BEPS are justifiable, even where they restrict a fundamental freedom.

[3] *Test Claimants in the Thin Cap Group Litigation v HMRC* (C-524/04) [2007] ECR I-2107; [2007] STC 906 (ECJ) at [79]–[81].
[4] *Marks & Spencer plc v Halsey* (C-446/03) [2005] ECR I-10837; [2006] STC 237 (ECJ).

Before concluding that an EU law challenge would be viable, it really is necessary to think forward to the context that might exist at the time such a challenge comes before the European Court.

Proportionality

Finally, Neidle suggests that the DPT is disproportionate because it lacks clarity and because there is a lack of opportunity afforded to the taxpayer to show that its arrangements are genuine. In the writer's view, this is not a valid criticism.

So far as certainty is concerned, the draftsman has clearly tried to identify the circumstances where the tax would apply, and to provide objective tests. At the end of the day, these are complex and artificial arrangements implemented by multinational groups with highly qualified advisors, and it really is not a very attractive argument to suggest that the groups that are liable to this tax (and who, by definition, will have acknowledged that they cannot show that these arrangements were not designed to avoid a PE or to take advantage of a tax mismatch outcome) cannot determine whether they are liable to the tax, or how much tax. The procedural elements of the tax require HMRC to state in the original charging notice why they consider that the DPT would apply, and also, in the case of alternative arrangements, to specify what those arrangements are. The taxpayer has an opportunity to appeal and to challenge that HMRC's approach is not just and reasonable. It is hard to see that this is out of line with any other anti-avoidance legislation where artificial arrangements are countered by authorities putting forward alternative arrangements that would have been entered into had the tax avoidance purpose not been relevant.

Equally, it is not correct to say that the taxpayer has a lack of opportunity to show that its arrangements are genuine. Built into the process are two stages where the taxpayer can make representations to the Revenue. First, in the initial 30 days when representations on a limited range of grounds must be considered. Secondly, during the subsequent 12 months when HMRC must review the charging notice. Given that in most cases the multinational groups concerned will have been in discussions with HMRC with regard to their transfer pricing and their structures for some time, it is really not a valid criticism to say that the taxpayer lacks the opportunity to show that its arrangements are genuine.

Concluding comments

Different people may take different views as to the impact of EU tax law, particularly having regard to the dynamic nature of the justifications. In that context, it is impossible to say categorically that a challenge under EU law would be doomed to fail, but there are some very real hurdles that a challenger would need to mount. Neidle has not identified all those hurdles, and his conclusion that it is doubtful the DPT would survive an EU law challenge risks falling at one of these hurdles.

But stand back from this technical discussion for a moment. The DPT targets similar arrangements to those that are the targets of the current BEPS Project. If it is the case that the DPT cannot be compatible with EU law, then it is hard to see how EU Member States could combat BEPS effectively within the scope of EU law. If Neidle were correct in his conclusion, then there is a much bigger problem than simply the DPT: Member States of the EU would have

to admit that there is little they could do to counter some of the core targets of the BEPS Project, like base-eroding payments, without falling foul of the European Court. That is an inherently surprising conclusion to reach, and should give a long pause before accepting Neidle's conclusion on an EU challenge. ☞

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☞ Base erosion and profit shifting; Corporation tax; Diverted profits tax; EU law; Justification; Multinational companies; Proportionality; Tax avoidance

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