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# The new UK Diverted Profits Tax

HMRC representatives have confirmed that the Government intends to press ahead with the introduction of the controversial new Diverted Profits Tax (DPT), referred to in the media as “Google Tax”. Speaking at an Open Day on 8th January and a conference on 13th January they said the Government intends to include DPT in the pre-election Finance Bill, presumably relying on cross-party support for a measure which appears to be popular with the electorate despite the misgivings of multinationals and their advisers.

The draft legislation was published in December and, while HMRC concede that it is not perfect and several aspects of it may require fine-tuning, it is likely to be rushed onto the statute book before all its flaws can be ironed out. The rush to legislate can be explained in part by the fact that it’s an election year in the UK and the UK Parliament’s Public Accounts Committee hearings focused attention on the tax affairs of Starbucks, Google and Amazon and highlighted public outrage at arrangements that were widely seen as being used by big corporates to aggressively avoid paying their fair share of tax. In addition the UK is a key supporter of the current G20/OECD international initiative on Base Erosion and Profit Shifting which is focused on introducing measures to combat aggressive tax avoidance. However, while the low effective rates of tax paid in the UK by such high profile companies may have prompted this new tax, the current draft of the DPT is not limited to just technology companies and coffee shops and it may potentially extend beyond the “aggressive” type of planning referred to in the Autumn Statement.

DPT, which will come into force with effect from 1 April 2015, aims to protect the UK tax base from erosion by preventing multinational enterprises from artificially moving profits outside the UK. It will impose tax at 25% on the amount of the “diverted” profits and apply to existing as well as new arrangements. Large companies will be obliged to notify HMRC of possible liability to DPT within three months of the end of the relevant accounting period and DPT will initially be paid on the basis of HMRC estimates of the amount of diverted profit, on a ‘*pay now argue later’* basis at least as far as quantum is concerned. This has the unfortunate consequence of potentially tying up cash even where a company may not in fact have a DPT liability.

DPT will be chargeable in the following circumstances:

- *PE avoidance*: this new tax law concept applies where foreign companies make large volumes of sales in the UK but minimise UK tax by ensuring that the sales are not concluded through a UK permanent establishment (PE). Typically such arrangements involve a UK subsidiary or “rep office” which undertakes the majority of UK sales activity and negotiations short of actually concluding the contract which is then done by the foreign company instead to ensure that the sales are not made through a UK PE. The DPT will also apply to other cases of PE avoidance.

- *Entities or transactions lacking economic substance:* this applies to UK companies (or UK PEs of foreign companies) minimising UK profits through transactions with, or payments to, low-taxed affiliates which lack economic substance. There appears to be significant overlap between this second limb of DPT and normal transfer pricing principles.

  Details of both provisions are set out below.

**PE avoidance**

There will be a DPT charge if:

- there is a non-resident company (FCo) which makes sales of goods and/or services to UK customers generating revenues of more than £10m a year, alone or when aggregated with connected companies;
- a person (the Avoided PE) is carrying on activity in the UK in connection with FCo's supplies of goods or services to UK customers;
- it is reasonable to assume that the activities of FCo and/or the Avoided PE are designed to ensure that FCo is not carrying on a trade in the UK through a PE, e.g. by ensuring that the Avoided PE undertakes all selling activities short of concluding the contracts with customers which is then done by FCo;
- the Avoided PE does not fall within the statutory exemption for certain agents of independent status, investment managers, brokers and Lloyds agents, or alternative asset managers;
- the Avoided PE and FCo are not both small or medium sized enterprises (SMEs);
- it is reasonable to assume that the mismatch condition and/or the tax avoidance condition are met;
- the mismatch condition is met if:
    - there are arrangements between FCo and another person (P) which give rise to a reduction in FCo’s tax, and the corresponding increase in P’s tax is less than 80% of FCo’s tax reduction; for this purpose P’s tax is computed on the basis that all reasonable steps have been taken to minimise P’s tax but no regard is had to any loss relief available to P so, if P has losses available to cover the profit, it will still be treated as paying tax;
    - the tax reduction (for FCo and P taken together) is greater than any other financial benefit referable to the transactions or the economic value provided by any person whose involvement in the transactions is designed to secure the tax reduction (the “insufficient economic substance test”);
    - the mismatch must be between parties which are not SMEs and which satisfy the participation test; i.e. one must participate directly or indirectly in the management, control or capital of the other or another person or persons must participate directly or indirectly in the management, control or capital of both parties; but
    - if the only provision between the parties is a loan relationship, that is not sufficient for the mismatch condition to be satisfied.
- the tax avoidance condition is met if the main purpose or one of the main purposes of the activities of the Avoided PE in relation to FCo's sales is to avoid a charge to corporation tax.

Where the conditions are satisfied, the starting point for calculating the DPT will be the tax which would have been payable if the Avoided PE had been an actual PE, that is as if FCo had been trading in the UK through a PE. Generally this will be subject to the normal CTA 2009 PE attribution rules. Where however, the mismatch condition is satisfied, the DPT computation may be adjusted to disallow all or part of FCo’s expenditure. This is illustrated in the second example below.

*Examples*

The HMRC DPT Guidance gives an example of a foreign company (FCo) acquiring widgets from a third party and selling them to customers in the UK. Its UK subsidiary (UKCo) undertakes all sales activity and negotiation of terms up to the point of concluding the contract with the customer which is done by FCo. There is no commercial reason for this contrived separation of the conclusion of contracts from UKCo's selling activity other than ensuring that UKCo does not constitute a PE of FCo. It is not necessary to satisfy the mismatch condition as the tax avoidance condition is satisfied. DPT will be calculated on the amount which it is just and reasonable to assume would have been FCo's chargeable profits for UK corporation tax purposes if it had been trading in the UK through a PE.

A second example is a scenario where there is both an Avoided PE and a tax mismatch. The FCo is the European sales and service hub of a multinational group. It is resident in an EU jurisdiction rather than a tax haven. FCo receives substantial sales revenues from customers in the UK but does not have a UK PE; its UK subsidiary's services are described as marketing and customer support and, while its staff have close relationships with customers, they do not complete the sales contracts. UKCo is an Avoided PE. However in assessing FCo to DPT, it is not sufficient simply to look at the profits made by FCo on its UK sales, because these profits have been reduced by tax mismatch arrangements between FCo and the group's IP holding company which is resident in a tax haven. FCo pays royalties to the IPCo (via CCo, another group company in a different EU jurisdiction, to avoid withholding tax) and there is a mismatch because FCo obtains a tax deduction for the royalties but CCo and IPCo are not taxed on them. The insufficient economic substance test is met in respect of the transaction with CCo, which is interposed solely to obtain exemption from withholding tax. DPT is calculated on the basis of a counter-factual scenario, the alternative provision which would have been made if the tax mismatch had not applied. This may deem the IP to be held by FCo itself (disallowing a deduction for royalties) or may alternatively substitute a reduced royalty payment; both would result in a reduction in FCo's deductible expenditure.

**Entities or transactions lacking economic substance**

The draft legislation is intended to catch situations in which a UK resident company or PE of a foreign company reduces its UK tax by payments to, or transactions with, a connected party where there is insufficient economic substance to the arrangements. The conditions for a DPT charge under this section are:

- there is a UK resident company or UK PE (both referred to here as UKCo);
- material provision has been made between UKCo and another person (P) by means of a transaction or series of transactions, other than merely a loan relationship;
- the participation test is satisfied between UKCo and P;
- UKCo and P are not both SMEs;
- the provision results in an effective tax mismatch between UKCo and P; and
- the insufficient economic substance test is met and it is reasonable to assume that the arrangement was designed to secure the tax reduction.

*Examples*

An example given in the Guidance is of a UK company which wants to invest in expensive plant and machinery for its UK trade. Its non-UK resident parent company injects capital into another subsidiary (C) in a tax haven to enable it to buy the equipment and lease it to the UK company. There is a tax mismatch because the lease payments are tax deductible in the UK but are not taxed in the tax haven. C has no full time staff, the contribution of its staff provides little economic value and that value is much less than the financial benefit of the UK tax reduction. DPT applies as if UKCo had bought the plant and machinery. Therefore the lease payments will be disallowed as deductions but UKCo will be entitled to capital allowances.

A further example involves a UK resident widget manufacturing company which develops new IP jointly with a third party company. UK Co has the opportunity to buy out the third party once the development is complete but a group decision is made to establish a new group company in a low-tax jurisdiction (IPCo) to acquire the IP, licence it to UKCo and charge UKCo a royalty for access to the third party patents. UKCo's UK tax liability is greatly reduced as a result of the royalty payments. It is assumed that UKCo would have bought the patents if it were not for the desired tax reduction so its DPT liability will be calculated as if it had bought the third party's patents. It will not be entitled to a deduction for the royalties but would presumably be entitled to amortisation relief for the imputed acquisition of intangibles.

This scenario is contrasted with the position of a group with a substantial group IP company which holds all group IP and has a large team which coordinates all R&D across the group and includes specialists who have experience to generate new ideas for development. In this case the economic value provided by the IPCo staff far outweighs the financial benefit of the UK tax reduction caused by UKCo's payment of royalties, so DPT should not be payable.

**Transfer pricing: interaction with DPT**

At first sight, it would appear that the UK transfer pricing rules should already prevent deduction of amounts which exceed arm's length rates, but DPT is intended to catch payments which are arguably of arm's length amounts but made under contrived arrangements by the parties concerned which lack economic substance. In computing DPT where there is a mismatch, it is necessary first to ascertain what provision would have been made in the absence of the differential tax rates.

If it is reasonable to assume that the alternative provision would have resulted in allowable expenses of the same type and for the same purpose as the expenses which result in the tax mismatch (even if paid in a different amount or to a different party such as IPCo rather than CCo in the second Avoided PE example above), then transfer pricing will apply to determine the permitted deduction for those expenses, taking into account the value provided by the payment recipient. If there are reasonable grounds for assuming that expenses are inflated, HMRC can impose a 30% deduction in its estimated charging notice, adjusting this later once the transfer pricing analysis has been completed. If the recipient of the payment would have been outside the charge to UK corporation tax there will be no further charge, but if the recipient in the alternative provision scenario would have been a UK company, then the chargeable profit would be increased by that amount.

However, if the alternative provision that would have been made in the absence of the tax mismatch would not have resulted in allowable expenses of the same type and for the same purpose, then it is assumed for DPT purposes that the alternative provision was made so no deduction for the expense is permitted. In the plant and machinery example above, the company is treated as if it had purchased the equipment itself so is not entitled to deductions for lease payment.

While a company with pre-April 2015 advance pricing agreements will not be able rely on these to exclude the possibility of liability to DPT, the APAs should help prevent the automatic 30% deduction which HMRC can make in their preliminary charging notice.

**DPT and the UK's international obligations**

The DPT legislation is a unilateral measure pre-empting the international Base Erosion and Profit Shifting (BEPS) project, although the Government insists it is still committed to the BEPS project. It had been assumed that international consensus would be needed for effective prevention of base erosion as it would require changes to double tax treaties. The UK's double tax treaties define what is and is not a permanent establishment and clearly provide that a foreign company is taxed on commercial income from the UK only if it is earned through a PE in the UK. Preparatory and auxiliary activities which stop short of concluding contracts do not generally constitute a PE, nor do Amazon-style warehousing and delivery activities. There may therefore be a risk that the introduction of DPT is inconsistent with the UK's double tax treaties. HMRC, supported by a prominent QC, maintains that DPT is a new tax not covered by UK tax treaties which apply to income tax, corporation tax and capital gains tax. This is not entirely clear as the treaties also apply to any taxes which are substantially similar to the named taxes. DPT will not be creditable against corporation tax but corporation tax and other UK taxes will be creditable against DPT. HMRC also has a back-up argument that, since DPT will only be applied to arrangements designed to exploit double tax treaties to avoid tax, the UK is not obliged to provide treaty relief. This relies on paragraphs 9.4 and 9.5 of the Commentary to Article 1 of the OECD Model Tax Convention.

HMRC say that considerable care has been taken to ensure compliance with EU law. They maintain that the tax is directed against arrangements that are abusive or contrived and designed to erode the UK tax base and that the tax is proportionate and gives taxpayers considerable opportunity to establish the commercial nature of their arrangements. Nevertheless, it arguably attacks a wider range of arrangements than the entirely artificial ones which the European Court of Justice said could be targeted by CFC legislation in its decision in the Cadbury Schweppes case. Nevertheless, if DPT were to be an infringement of EU law, then the BEPS proposals would run into similar difficulties.

The initial international reaction to DPT appears to have been muted. HMRC say that the US reaction has been "calm" as they accept that the status quo is not sustainable. It may be that other countries will follow the UK example and not wait for the completion of the BEPS process, rather as the US FATCA legislation spawned a number of similar disclosure regimes across the world.

**Compliance**

A company will be obliged to notify HMRC of possible liability to DPT within three months of the end of the relevant accounting period but will not be required at that stage to quantify the profit potentially liable to DPT. The draft criteria for notification are wider than for actual liability, raising concern about huge numbers of precautionary notifications, but HMRC accept that the drafting needs to be tightened up. HMRC then has up to two years from the end of the accounting period to issue a preliminary charging notice specifying how the estimated charge is calculated and who must pay. The company then has 30 days to make written representations but HMRC can only consider representations on specified matters at this stage (mainly on application of the exemptions) and is not required to consider representations on transfer pricing or attribution of profit to PEs. Within 30 days of the end of that 30 day representation period, HMRC must either issue a charging notice or notify the company that no notice will be issued. The company must pay the tax within 30 days after the issue of the notice. No postponement will be permitted. HMRC can require a related company to pay the tax if the targeted company does not. DPT may therefore become payable before the usual corporation tax payment date following this compressed timetable, but the initial payment will be followed by a 12 months review period during which the company may be able to secure an adjustment to the tax payable, for instance after a transfer pricing analysis to replace the automatic 30% reduction in deductible expenditure which may have been applied by HMRC in its earlier charging notice. Like the new follower and accelerated payment notices introduced last year, DPT is to a large extent a "pay now and argue later" type of tax.

If you require further information or would like to discuss DPT with our tax group, please contact Mark Joscelyne, Batanayi Katongera, Pat Dugdale, Matthew Wentworth or your usual Olswang tax contact.