BLICK ROTHENBERG
Chartered Accountants

Diverted Profits Tax

The Diverted Profits Tax ("DPT") is a new tax which has been introduced into UK law with remarkable haste. The Chancellor first announced the Government's intention to introduce such a tax during his Autumn Statement on 3 December 2014 and it was enacted as part of the Finance Act 2015 on 26 March 2015. The popular press have dubbed the new tax as the "Google" tax, the reasons for which will become very apparent as you read these notes.

Overview

When announced during the Autumn Statement, the Government's stated intention was to "introduce a new tax to counter the use of aggressive tax planning techniques used by multinational enterprises to divert profits from the UK." The DPT achieves its objective of "countering the use of aggressive tax planning". However, it goes further than just taxing profits diverted from the UK to taxing profits that, under general tax principles, would not otherwise be subject to UK tax, but which are not being taxed elsewhere at a rate of at least 16% (i.e. at 80% or more of UK corporation tax rate) and have some connection to the UK.

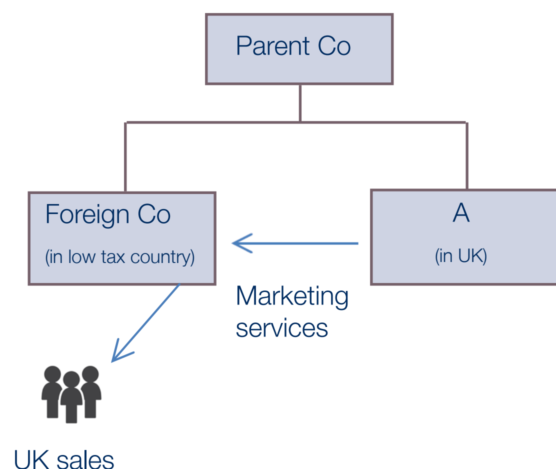
Main features of DPT:

- DPT applies from 1 April 2015.
- Rate of DPT will be 25%.
- It will not apply to small or medium-sized enterprises ("SMEs") - (n.b. this is based on the EU definition of SME and a group company will only be an SME if the group satisfies the SME test.) Therefore, DPT will not apply where a group has less than 250 staff and its revenues are less than €50m, and/or its balance sheet is no more than €43m.
- DPT will potentially apply in two types of circumstances:
    1. Where despite activity being carried on in the UK a company avoids carrying on a trade through a UK permanent establishment ("Avoided PE"); and
    2. Where an intra-group expense has been created (or there is a diversion of intra-group income) where the arrangements lack economic substance, exploit a Tax Mismatch and it is "reasonable to assume", absent the tax benefit, that the expense would not have been incurred (or the income would have been received in the UK).
- DPT will not apply to an Avoided PE unless annual UK sales are more than £10m.
- DPT will also not apply to an Avoided PE if the UK-related expenses (i.e. those referable to UK activity) do not exceed £1m in the 12 month accounting period.
- DPT will also not apply where, essentially, overseas tax is being paid on the "diverted" profits which is at least equal to 80% of the UK corporation tax otherwise payable.
- Liability to DPT is not self-assessed but there is a disclosure requirement. The charge is then created by HM Revenue & Customs ("HMRC") issuing a charging notice.
- DPT is not an extension of corporation tax and in HMRC's view, it is not covered by tax treaties and is EU compliant.

Case 1: The Avoided PE

This case is aimed at the "Google type" of arrangement where sales are made to customers in the UK by a foreign company that has no permanent establishment/taxable branch in the UK.

The foreign company does, however, have a subsidiary or other related company in the UK that carries on an activity that is related to the supply of services, goods or other property made by the foreign company. At its simplest this case potentially applies to situations as shown in the following diagram:



More precisely, the Avoided PE cases apply where:

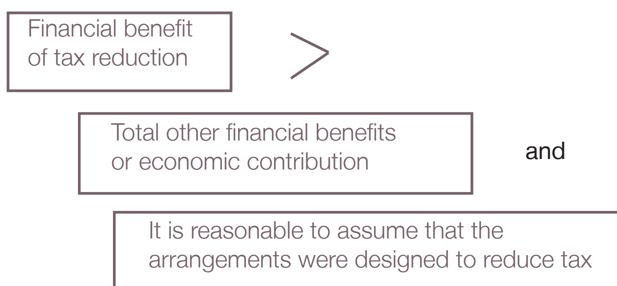
- A non-UK resident company ("Foreign Co") carries on a trade in an accounting period;
- Another person ("A") carries on an activity in the UK in connection with the supply of services, goods or other property made by Foreign Co in the course of that trade;
- It is "reasonable to assume" that the activity of A or Foreign Co (or both) is designed to ensure that Foreign Co has no UK PE of its own by reason of activities of A (whether or not it is also designed to secure any commercial or other objective);
- Either or both of the following conditions (described in detail below) are met:
  - The Mismatch condition; or
  - The Tax Avoidance condition.

  and

- The various exceptions do not apply. Specifically:
  - Foreign Co and A are not both SMEs;
  - UK annual sales exceed £10m;
  - UK related expenses exceed £1m;
  - A is not an agent of independent status and in addition the "participation condition" is met. In broad terms, Foreign Co and A will meet this condition if they are members of the same group (n.b. this condition is broadly defined in terms of management, control or capital);
  - The material provision (e.g. the service provided by A) is not a provision relating to financing arrangements; and
  - The tax mismatch does not arise solely by reason of: contributions by an employer to a registered or overseas pension scheme; a payment to a charity; a payment to a person exempt from tax due to sovereign immunity; and certain payments to an offshore fund or authorised investment fund where the funds are widely held and where 75% or more of the investors in the fund are charities, pension schemes or persons exempt from tax due to sovereign immunity.

The "Mismatch Condition" is met where:

- Participation condition is met (broadly, Foreign Co and A are connected); and
- In connection with the supply of services, goods or other property, arrangements are in place ("the material provision") that result in an effective tax mismatch outcome between Foreign Co and A (i.e. Foreign Co's tax liability is less than 80% of the Avoided PE's UK corporation tax liability – i.e. less than 16%); and
- The insufficient economic substance condition is met, i.e.



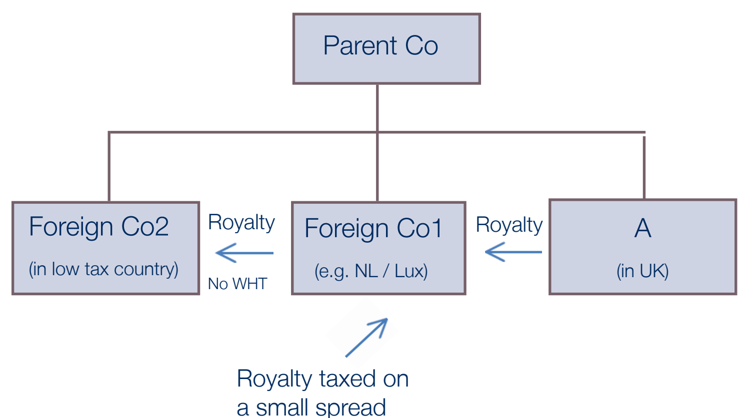
The "Tax Avoidance Condition" does not need to be met where the "Mismatch Condition" is satisfied. Therefore, there does not need to be a "Tax Avoidance" motive in order for the DPT to apply if the "Mismatch Condition" is satisfied. The "Tax Avoidance Condition" will be met where, in connection with the supply of services, goods or other property, arrangements are in place; one of the main purposes of which is to avoid a charge to UK corporation tax.

Comments

- "Google type" structures: As its nickname suggests the DPT is designed to tax the "Google type" of structures known as "Double Irish" structures. These structures have been used by a number of US multinational groups and result in little or no tax being paid on sales made from an Irish incorporated/Bermudan resident company. It is the sales made to UK customers from the Irish incorporated company that could potentially be within the scope of DPT.
- Land and property: The original draft legislation on Avoided PEs required there to be a supply of goods or services as a result of UK activity. The legislation, as now included in the Finance Act, has been amended to put beyond doubt that DPT may apply to sales of property in the same way as to other goods and services. Therefore, DPT potentially applies to offshore companies owning UK commercial property where another UK resident group company manages the property or undertakes property development work for the offshore investment company. Consequently, DPT potentially applies to a hotel group where the operating company is a UK resident company but the property owning company is a non-resident company.
- Oil and gas ring fenced companies: It is anticipated that the DPT could apply to such companies and specific provisions have been included to set the rate of DPT for such companies at 5% above their UK tax rate (i.e. 55%, which is 30% + 20% supplementary charge + 5%).

Case 2: Intra-group expense (or diversion of income) and lack of economic substance (of entities or transactions)

This case is aimed at circumstances where a UK company pays a royalty (or similar expense) to a Foreign Co but the income received by the Foreign Co is not taxed at an amount equivalent to 80% of the UK corporation tax rate (i.e. 16% or more) on those profits. The situation might be as shown by the following diagram:

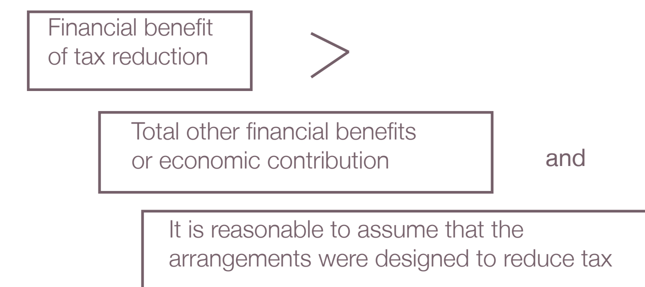


More precisely, Case 2 applies where:

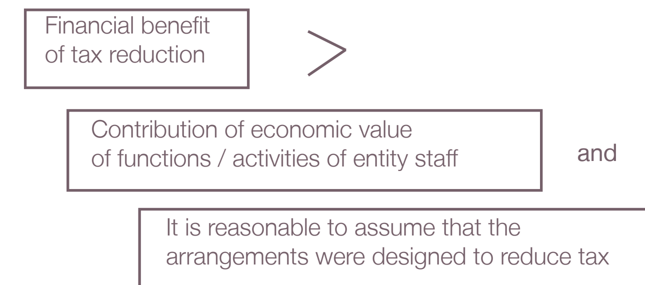
- A "material provision" is made between A and another person ("Foreign Co1") by means of a transaction or series of transactions (n.b. A is a UK resident company or a non-UK company trading in the UK through a permanent establishment);
- The participations condition is met (e.g. Foreign Co1 and A are connected persons);
- The "material provision" results in "an effective tax mismatch outcome" between Foreign Co1 / Co2 and A;
- The "material provision" is not an excepted loan relationship;
- The "Insufficient Economic Substance" condition is met; and
- Foreign Co1/Co2 and A are not both SMEs (n.b. test on a group basis so both or neither are likely to be SMEs).

The "Mismatch Condition" applies, broadly, as in case 1 where, essentially, Foreign Co1/Co2 does not pay tax on its income at 16% or more (i.e. 80% of UK corporation tax rate). As the "material provision" applies to both a transaction and to a series of transactions, the mismatch condition is tested between A and Foreign Co1 as well as between A and Foreign Co2. As Foreign Co2 is in a low taxed country and A's profits are taxed in the UK, there is an effective tax mismatch outcome.

The "Insufficient Economic Substance Condition" is met if either:



or



The above provisions apply where A has increased the tax deductible expense or decreased the taxable income.

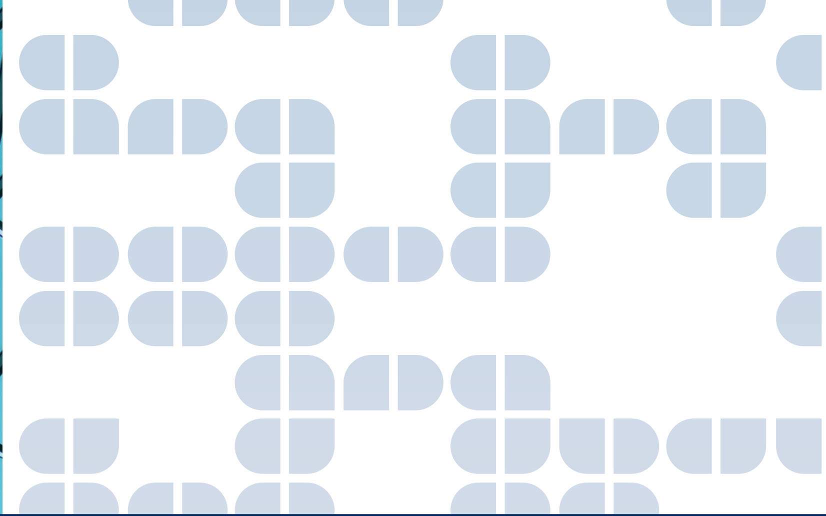
Comments

- Reinsurance Companies: A large multinational insurer may have a large number of staff in the UK as well as in other countries across America, Asia and Europe. The UK company will typically reinsure part of the written business with the group reinsurer, a company that may be located in, say, Bermuda. The group reinsurer will have a modest number of skilled underwriters and actuaries. DPT is potentially applicable and so the group will need to consider whether the non-tax financial benefits referable to the reinsurance outweigh the financial benefit of the tax reduction. In this case, the more efficient capital structure is a quantifiable non-tax financial benefit and, where the facts show that this is greater than the tax saving, there will be no DPT charge.
- **Partnerships:** Where the foreign company is a member of a partnership, the company is treated as if it were carrying on its part of the trade of the partnership directly.

Summary of DPT Tax Process for notification, charging and paying

1. The company is required to notify if it is potentially within the scope of DPT within three months after the end of the accounting period. HMRC's guidance notes have indicated that this period is extended to six months for the first accounting periods affected by the introduction of the DPT. If the company does not make the notification it may be liable to a tax-geared penalty.
2. HMRC may issue a preliminary notice of chargeability within two years after the end of the accounting period (this is increased to four years if there was no notification by the company).
3. The company has 30 days from issue of the notice to make representations.
4. HMRC must consider representations on certain factual matters and threshold conditions and must then either issue a charging notice, or confirm that no charging notice will be issued, within 30 days from the end of the representation period. The charge to tax may include an interest element ("true up interest") on the DPT, running from six months after the end of the accounting period to the date the charging notice is issued.
5. The company must pay the DPT within 30 days from the issue of the charging notice and there is no right to postpone the tax.
6. HMRC then has a further 12 months from the relevant payment date to review the charging notice. During this period, HMRC may issue a supplementary charging notice or appropriate amending notices increasing or reducing the DPT.
7. The company then has 30 days from the end of the review period to appeal or the DPT becomes final.

   The keen reader will have observed that HMRC is permitted long periods of time to decide on and to take action whereas the company is permitted very little time to take its actions.



Calculation of taxable diverted profits

In estimating the taxable diverted profits to be included in a notice, the designated HMRC officer is to make a best estimate of the amount that is chargeable. However, there are specific rules that apply to determine the estimated charge where an "inflated expenses condition" is met. Under these rules there is a 30% disallowance of payments that are responsible for the tax mismatch outcome, and which the designated officer considers might exceed an arm's length amount. This 30% reduction is made without regard to transfer pricing considerations.

Provision is made for a credit to be given against the liability for DPT where UK corporation tax or foreign tax has been paid on the same profits being charged to DPT.

Collection of tax

Any DPT which is due from the Foreign Co may be collected by HMRC from a UK representative. Any DPT which remains unpaid after the due date (i.e. 30 days from the issue of the charging notice) may be collected by HMRC from a related company. DPT is payable by such a related company within 30 days of the serving of a notice to pay by HMRC.

Final comments

DPT is a new tax and its application is potentially very broad. HMRC have some challenging issues in ensuring the tax is enforced on non-UK resident taxpayers and these issues are not fully addressed by the legislation. The government may also wish to review the tax at a future date after the Organisation for Economic Co-operation and Development's ("OECD") Base Erosion and Profit Shifting ("BEPS") project has concluded and a more general international approach to addressing the avoidance of tax by multinational companies has been agreed. However, for now, DPT is law and it is here until Parliament changes it.

For more information, please contact:

Nilesh Shah
Partner - Head of Tax
+44 (0)20 7544 8866
nilesh.shah@blickrothenberg.com

Paul Smith
Partner
+44 (0)20 7544 8823
paul.smith@blickrothenberg.com

Blick Rothenberg LLP
16 Great Queen Street
Covent Garden
London WC2B 5AH

+44 (0)20 7486 0111

www.blickrothenberg.com

Blick Rothenberg LLP is authorised and regulated by the Financial Conduct Authority to carry on investment business.

Independent Member of BKR INTERNATIONAL