International Tax

United Kingdom Tax Alert

11 December 2014

Draft legislation on diverted profits tax released

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The UK government published further details on the new diverted profits tax (DPT) on 10 December 2014, including draft legislation for Finance Bill 2015 and a Technical Note with some examples of cases where the UK tax authorities, HM Revenue & Customs (HMRC), consider that the DPT could apply. The introduction of the DPT was originally announced in the Autumn Statement 2014 (see the alert dated 4 December 2014).

The DPT is scheduled to apply as from 1 April 2015 at a rate of 25% to profits of multinationals that are artificially diverted from the UK. The DPT will be separate and distinct from corporation tax and is intended to encourage companies to adjust their corporate tax position to reflect the expected outcomes from the G20/OECD base erosion and profit shifting (BEPS) project. The UK government considers that the DPT will fall outside the scope of the UK's existing tax treaties and the tax is not aimed at financing.

Scope of DPT

The DP) will apply in two distinct situations:

1) Where a foreign company has artificially avoided having a taxable presence (permanent establishment (PE)) in the UK; and/or
2) Where a group has a UK company (or UK PE of an overseas company) and there is a tax advantage as a result of an entity or transactions that lack economic substance.

In both cases, there is a requirement that there be activity (people) in the UK. The rules are focused on profit that would have arisen in the UK if the arrangements had not been implemented, and is not intended to bring within the charge to UK tax activities carried on by persons in other countries. Broadly speaking, a tax advantage will be deemed to arise where the overseas tax is less than 80% of the UK tax that would have applied. Income taxed in high tax countries will not be subject to the DPT.

An exemption from the DPT will apply in the following cases:

- For small and medium-sized businesses (based on the existing interpretation of the EU limits used in the UK's transfer pricing

legislation); and
- Where total the UK sales made by the group are less than GBP 10 million per annum.

Situation 1: Artificial avoidance of a UK PE (also referred to as a "section 2 charge")

The DPT will apply where a foreign company makes substantial sales (of goods or services) in the UK while avoiding the creation of a UK PE; for example, where there are significant sales activities in the UK, but no conclusion of contracts. A PE will be considered to have been avoided if:

- A connected party is carrying on activities in the UK in connection with the supply of goods or services by a foreign company to UK customers. (This is termed a "material provision.");
- The arrangements are designed so that the foreign company does not have a UK PE. It does not matter whether there are any commercial or other objectives;
- Either or both of (i) a tax mismatch condition (which includes a requirement for there to be a lack of economic substance), discussed further below, or (ii) a tax avoidance condition are satisfied; and
- The tax avoidance condition is that the main purpose, or one of the main purposes, of the arrangement is to avoid the charge to UK tax.

Situation 2: Recharacterization of intragroup transactions involving a lack of economic substance (also referred to as a "section 3 charge")

The DPT also will apply where a UK company is party to arrangements involving "provisions" (broadly meaning transactions or a series of transactions, as termed in the UK's transfer pricing rules) between it and another group company, where:

- A material provision has been made (a transaction or series of transactions) between connected parties; and
- A tax mismatch arises, including a requirement that there be insufficient economic substance.

This approach also will be extended to situations where a non-UK resident company trades through a UK PE.

Tax mismatches

Certain conditions will have to be satisfied for a tax mismatch to arise (in relation to either situation). There will have to be an increase in deductible expenses or a reduction in taxable income of either (i) the foreign company that has avoided a UK PE (under the section 2 charge), or (ii) the UK company (under the section 3 charge) or UK PE.

Broadly, a tax mismatch relates to the tax reduction from comparing the rate of tax that would have applied (to (i) the foreign company, or (ii) the UK company/UK PE, depending on the circumstances) with the tax actually paid in other countries on the diverted profits, including any withholding tax suffered. In calculating this reduction, losses utilized in the company elsewhere will be disregarded, but all other claims, elections and deductions will be presumed to have been made. Under a "hurdle test," there will not be a tax mismatch unless the tax paid elsewhere on the diverted profits is less than 80% of the equivalent actual tax payable (again excluding the effect of losses).

For there to be a tax mismatch, the tax reduction will be considered further by reference to economic substance. The insufficient economic substance requirements have three tests, and only one prong will have to be satisfied for a tax mismatch to exist:

- The first two tests consider whether the tax reduction is greater than "any other financial benefit" applied to a single transaction or a series of transactions.
- The third test is a broader entity-based test and considers the overseas entity's contribution of economic value, in terms of functions and activities of its people. The test will be met if the tax reduction is greater than the contribution of economic value.

The important point to note in relation to the avoidance of a PE case is that this test also looks at onward payments by the foreign company to a low-tax jurisdiction. It is aimed at situations where a company in a treaty or EU country is the one transacting with the UK, but it itself has only a small margin as a result of on-payments to low-tax countries where there may be little substance.

Calculating the DPT

There are two stages to the calculation of the DPT:

1. HMRC will make an initial estimated charge based on its best estimate of the DPT due. However, there is a presumption that where HMRC considers that expenses are or may be inflated (to create a tax mismatch and involving a lack of economic substance) that the expenses should be reduced by 30% in calculating the DPT. At this estimation stage, there will be no requirement for HMRC to assess fully whether the transactions are at arm's length under the transfer pricing rules.

2. HMRC will calculate the DPT based on the facts and circumstances, but assuming that an alternative provision (transaction or series of transactions) is substituted for the material provision (the actual transaction(s) undertaken). HMRC will have discretion in determining the alternative provision, provided it is just and reasonable, and in some cases, HMRC may conclude that the alternative would be to assume that there would have been no transactions at all.

In relation to avoided PE cases, this will apply to assume a PE of the foreign company in the UK, and also will negate any effects of excessive expenses flowing through the foreign company to a low-tax jurisdiction where there is little or no substance. In relation to recharacterization of intragroup transactions involving a lack of economic substance, the alternative provision will negate the transactions or series of transactions.

In both cases, the calculation of the DPT will include credit for any UK tax or any overseas tax paid on the profits, including withholding tax suffered.

Notification, assessment and penalties

Since the DPT is a new tax, it will have its own administration system. It will not form part of the corporate tax self-assessment system, and will be an assessed tax. HMRC must issue a "notice" of the DPT charge. The process will be as follows:

- A company will have to notify HMRC that it is potentially within the scope of the DPT within three months of the end of the accounting period. A penalty may apply if there is a failure to make this notification.
- HMRC then may issue a preliminary notice that there is a DPT charge within two years of the end of the accounting period (or four years if there has been no notification).
- The company will have 30 days to make representations on the preliminary notice.
- HMRC will have a further 30 days to either issue a charging notice or confirm no notice will be issued.
- The company will have to pay the DPT in the charging notice within 30 days, together with any interest due from six months after the end of the accounting period. There will be no right to defer payment or to appeal against this notice. Penalties and interest for late paid tax will apply if the tax is not settled when due.
- HMRC then will have 12 months to review and potentially amend the charging notice.
- The company will have 30 days to appeal the charging notice after the review period or it will become final.

Ultimate resolution of any disputed charge will be through the UK tax tribunal and courts.

Timetable and implementation

The DPT will apply to diverted profits arising on or after 1 April 2015. Accounting periods that straddle 1 April 2015 will need to be split between pre- and post- 1 April, with diverted profits apportioned on a just and reasonable basis.

Deloitte comments

The UK's move is a surprise, given the UK's general commitment to the multilateral process underpinning the BEPS project. It is clear that the UK would like to encourage multinationals that have structures potentially affected by the BEPS project to change at least the UK aspects of those structures. In fact, the provisions have been written to remove a charge to the new tax where those adjustments are made, even after the end of the accounting year. The tax rate specifically encourages this, since the DPT is 5% higher than the regular 20% corporation tax.

The proposals say they are intended to catch artificial arrangements not supported by economic substance, which references language used in the BEPS project. The DPT will apply where there is a tax advantage for a multinational group and it is reasonable to assume that the alternative would be for additional profits to be taxed in the UK. The tax is not intended to apply to profits from activities carried on outside the UK, supported by people.

At this stage, before the G20/OECD publishes the agreed Actions on Transfer Pricing and Permanent Establishment – due in September 2015 – companies will be justifiably concerned that they do not yet have sufficient information on which to make structural changes, or to comply with this new tax. Concepts such as "economic contribution to value" require definition, preferably on a multilateral basis.

The new tax is designed to sit outside the UK's tax treaties, and as such will not be limited or supported by treaty clauses such as PE provisions, rules on the taxation of business profits, access to double tax relief and mutual agreement procedures and exchange of information between governments.

Regrettably, the draft legislation is complex and badly drafted. HMRC will hold an open day on the DPT on 8 January 2015, and comments on technical aspects are invited at divertedprofits.mailbox@hmrc.gsi.gov.uk. The government says it is committed to introducing the legislation and, whilst it welcomes comments on the detail does not expect to make significant changes to the structure of the tax.

Dbriefs webcast

There will be a special webcast in the EMEA Dbriefs program on the DPT on 18 November 2014 at 2.00pm GMT. To register for the webcast, go to http://deloi.tt/1vToGLQ or www.emeadbriefs.com.