UK CLIENT MEMORANDUM | ENGLISH LAW UPDATES

Impact of the New UK Diverted Profits Tax on the London Insurance Market

16 December 2014

AUTHOR

Judith Harger

Following heated press coverage and public disquiet about tax avoidance by multinationals, the UK government plans to introduce a Diverted Profits Tax (**DPT**), known colloquially as the "Google Tax". The announcement in the Autumn Statement on 3 December 2014 came as a surprise to the business community. It has now been followed by the publication of draft legislation, together with guidance from Her Majesty's Revenue and Customs (**HMRC**).

Scope of the DPT

The DPT is a new tax. It is intended to be separate from the existing UK corporation tax that is charged at a rate of 21% (due to fall to 20% from 1 April 2015). DPT will be charged at the (apparently deterrent) rate of 25%.

It will apply from 1 April 2015, with an apportionment of profits, on a just and reasonable basis, for any accounting period that straddles this date.

There are two main limbs of the DPT, the first of which turns on the fact that a non-UK resident company is liable to UK corporation tax if it carries on a trade in the UK through a UK permanent establishment. "Permanent establishment" includes a dependent agent who habitually exercises authority to conclude contracts on behalf of the non-resident. According to HMRC, this first limb catches the profits of a non-resident company attributable to economic activities in the UK that are intended to avoid the creation of a "permanent establishment". HMRC guidance refers to "contrived arrangements used by large groups (typically multinational enterprises) that result in the erosion of

the UK tax base" and states that this includes, for example, arrangements involving significant sales activity in the UK that are designed to stop short of the conclusion of contracts.

The second limb of the DPT applies where there is a transaction, or series of transactions, between a UK company (or UK branch of a non-resident company) and another person under common control and there is a tax mismatch outcome.

Both limbs involve a comparison between the economic value contributed (in terms of the functions or activities performed by the staff of a transacting party) with the financial benefit of the tax reduction. This means that any transactions with a non-resident company in a low tax jurisdiction, like Bermuda, will need to be considered carefully.

Impact on the Insurance Sector

Although the political origins of DPT lie in the field of consumer products and markets, the draft legislation published on 10 December 2014 is very widely drawn and could equally well, on its terms, apply to the commercial financial services sector. This includes (re)insurance groups, ILS funds and other third-party asset management businesses.

The possible impact of the DPT on the insurance industry will become clearer following the consultation on the draft legislation. As it currently stands, one can see a potential impact on an arrangement, where a UK intermediary analyses and negotiates an insurance policy with a potential cedant or its broker on a non-binding basis, and then sends a detailed proposal to its non-UK insurance company client for review, finalisation of the contract and, if thought appropriate, conclusion.

Another scenario, that is less obviously within the sight lines of the DPT but may be potentially vulnerable, concerns a common feature of a multinational (re)insurance group whereby a UK business provides sales and marketing services to a foreign affiliated risk carrier. Typically, any useful contacts with potential insureds or their brokers identified by the UK entity will be immediately referred to the fellow group member for taking forward by its foreign underwriting team. The UK activity would not usually go any way down the path of discussing the terms of a particular piece of business. It is unclear whether the DPT is intended to apply at all in that situation and, if so, what proportion of the non-UK insurer's profits would be taxed.

Exceptions

Importantly, the DPT under the first limb is not triggered unless there are supplies to "customers in the UK" made by the company (together with connected companies) that exceed £10 million per annum. This term is not defined in the draft legislation and it is not clear what UK nexus is envisaged here, but it may offer some protection to (re)insurance businesses writing policies in the London market for international customers.

The current corporation tax permanent establishment exception for an independent agent acting in the ordinary course of its business will also apply to the DPT under the first limb, *provided* (unless the agent is protected by the investment manager exemption (**IME**) or the independent broker safe harbour) that the avoided PE and non-resident company are not connected with each other.

Critical Response

The DPT measure may come under international pressure. It arguably undermines the current network of double tax treaties with the UK and/or the European Union freedom of establishment principle. There might be scope for a company that is resident in an EU or treaty jurisdiction to challenge a DPT liability on that basis.

Furthermore, the measure effectively jumps the gun on efforts by the Organisation for Economic Co-operation and Development (**OECD**) to coordinate multilateral action on international tax rules through the Base Erosion and Profit Shifting project (the **BEPS Project**). Indeed, on 31 October 2014, the OECD published "BEPS Action 7: Preventing the Artificial Avoidance of PE Status'" which proposed a widening of the definition of permanent establishment in double tax treaties. The proposals include some changes that move in a similar direction as the DPT, replacing the definition of a dependent agent permanent establishment from a person who "concludes contracts" to a person who "engages with specific persons in a way that results in the conclusion of contracts" or "negotiates the material elements of contracts".

The DPT in its current draft form has been heavily criticised domestically. Despite the widely-held view that the legislation is poorly drafted, HMRC has stated that it will consult only on the details and will not consider substantive changes. Nevertheless, the (re)insurance industry will be particularly disappointed given the UK government's assurance in the Autumn Statement that, building on the UK's position as a world leader in the global insurance market, the government would explore options to ensure that the UK's regulatory and tax regime is as competitive as possible to attract more reinsurance business to the UK. One can predict intense lobbying to clarify and refine the scope of DPT, both in the insurance industry context and more generally.

If you have any questions regarding this memorandum, please contact Judith Harger in London (+44 20 3580 4705, jharger@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

16 December 2014

Copyright © 2014 Willkie Farr & Gallagher LLP.

This memorandum is provided by Willkie Farr & Gallagher LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum may be considered advertising under applicable state laws.

IRS Circular 230 disclosure:

To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

WILLKIE FARR & GALLAGHER (UK) LLP

* Willkie Farr & Gallagher (UK) LLP is a limited liability partnership formed under the laws of the State of Delaware, USA and is authorized and regulated by the Solicitors Regulation Authority with registration number 56565.