UK CLIENT MEMORANDUM | ENGLISH LAW UPDATES

New United Kingdom Tax on Cross-Border Tax Planning: Diverted Profits Tax

5 February 2015

AUTHOR

Judith Harger

Introduction

Following heated press coverage and public disquiet about tax avoidance by multinationals, and with a general election on the horizon, the United Kingdom government has announced 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 It was followed by the publication of draft legislation, together with draft guidance from Her Majesty's Revenue and Customs (**HMRC**).

Much of the original debate concerned businesses selling products to consumers in the UK but the proposed DPT regime is broad, so that it is applicable to all industry sectors, and is particularly relevant for group structures that involve:

- people carrying on sales and marketing activities in the United Kingdom to UK customers, where the resulting profits are ultimately booked in a low-tax jurisdiction; or
- taxable United Kingdom trading profits being reduced by expenses in the form of intra-group payments, e.g. intra-group royalties, reinsurance premiums or lease payments.

A New Tax

DPT is targeted at supposed weaknesses in UK tax law regarding the definition of a permanent establishment (**PE**) and the scope of the transfer-pricing regime. A secondary aim is to accelerate full and early disclosure of information that might trigger an HMRC transfer-pricing examination.

DPT is a new tax, intended to be separate from the existing UK corporation tax (charged at 21% and 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.

The UK government's position is that double tax treaties offer no protection against DPT.

Two Limbs

There are two main limbs of DPT:

- Section 2 charge, which applies where a foreign company with sales into the United Kingdom organises its affairs in such a way as to avoid creating a taxable presence (in the form of a PE) in the United Kingdom; and
- Section 3 charge, which applies where a company that is taxable in the United Kingdom enters into a transaction or series of transactions, with one or more connected persons who lack economic substance, that exploits tax differentials between the entities.

Avoided PE – Section 2

The first limb addresses the problem of activities being deliberately designed to fall short of creating a PE. The framing of the Section 2 limb turns on the fact that a non-United Kingdom resident company is only liable to UK corporation tax if it carries on a trade in the United Kingdom through a PE in the United Kingdom, with a "permanent establishment" being defined to include a dependent agent who habitually exercises authority to "do business" (or, under the slightly narrower terms of many UK double tax treaties, "conclude contracts") on behalf of the non-resident.

DPT applies where a person (the **avoided PE**) carries on activity in the United Kingdom in connection with supplies of goods or services made by a non-United Kingdom resident company to customers in the United Kingdom in circumstances where

- the avoided PE is not a United Kingdom permanent establishment;
- it is reasonable to assume that any of the activity of the avoided PE or non-United Kingdom resident company is designed (for example, by way of agreed limitations on their respective activity) to avoid the creation of a United Kingdom permanent establishment (whether or not it is also designed to secure any commercial or other objective); and
- it is reasonable to assume that there is an "effective tax mismatch outcome" and/or that one of the main purposes of the arrangements is the avoidance of corporation tax.

The “effective tax mismatch outcome” condition essentially looks at whether, in connection with the supply of goods or services, a transaction (other than a loan) between the non-resident company and a connected party reduces the overall tax liability by at least 20% and an economic substance test is failed. These concepts are similar to the corresponding ones for the Section 3 charge, discussed below.

The tax avoidance condition is objective and does not rely on the actual intentions of the parties. HMRC has commented that the tax avoidance condition would be met if the arrangement would not have been carried out at all were it not for the opportunity to avoid a UK corporation tax charge or where any non-tax objective was secondary to the benefit of obtaining the tax advantage.

Where the first DPT limb applies, the taxable diverted profit is the amount that is just and reasonable to assume would be the taxable profit for corporation tax purposes, computed in accordance with Organisation for Economic Co-operation and Development (**OECD**) PE profit attribution principles, had the avoided PE been a United Kingdom PE through which the foreign company carried on the relevant trade in the United Kingdom.

If the non-resident company has itself reduced its profits artificially by making base-eroding payments, so as to satisfy the “effective tax mismatch outcome” condition, this will potentially include a transfer-pricing examination of the pricing of the foreign company’s dealings, including with other non-United Kingdom resident affiliates. In addition, if it is reasonable to assume that the relevant transaction would not have been entered into at all in the absence of the tax mismatch, then those payments are ignored altogether, in quantifying the foreign company’s profit base potentially available to be attributed to the PE, and replaced with the notional cash flows of an assumed alternative transaction, on a just and reasonable basis.

Free-standing Effective Tax Mismatch Outcome – Section 3

The second limb of DPT applies where there is a transaction, or series of transactions, between a UK-resident company (or United Kingdom branch of a non-resident company) and another person under common control, where the “effective tax mismatch outcome” and the “insufficient economic substance” conditions are met.

The “effective tax mismatch outcome” condition is similar to the Section 2 version but, in this context, looks at whether a transaction or series of transactions (other than a loan) between the UK corporation tax payer and one or more connected persons reduces the overall tax liability by at least 20%. Any transactions between a UK business and a low-tax jurisdiction affiliate or an affiliate that benefits from a specific local tax exemption will therefore need to be considered.

The “insufficient economic substance” condition is satisfied if either (a) the financial benefit, taken as a whole for both parties, of the tax reduction is greater than any other financial benefit referable to the transactions and it is reasonable to assume that the arrangements were designed to secure the tax reduction, or (b) the contribution of economic value to the transaction of the person, in terms of the functions or activities of its staff, is less than the value of the financial benefit of the tax reduction, and it is reasonable to assume that the person’s involvement in the transaction was designed to secure the tax reduction (whether or not it is also designed to secure any commercial or other objective).

These provisions could capture transactions even where the non-tax financial benefits were significant. A special purpose vehicle is likely to be vulnerable to an "insufficient economic substance" challenge.

Where second limb DPT applies, the taxable diverted profit will be calculated initially by reference to arm's-length transfer-pricing of the transactions that have actually taken place. If a transfer-pricing adjustment would otherwise have been appropriate, the effect of DPT is to alter the balance of risk between the taxpayer and HMRC because the DPT liability is higher, and payable earlier, than an additional corporation tax liability would have been.

Again, as in relation to first limb DPT, it is open to HMRC to recharacterise and substitute alternative transactions that it is just and reasonable to assume would have been implemented in the absence of a tax mismatch. (There are some echoes here of the familiar "thin capitalisation" question as to whether the intra-group financing would have been entered into at all in the absence of the relationship between the parties.)

Geographical Scope of the Section 2 DPT Charge and the Sales Threshold Exemption

The Section 2 charge will apply where the avoided PE is "carrying on activity in the United Kingdom in connection with supplies of goods or services made by the foreign company to customers in the United Kingdom", subject to an exemption where the total sales revenue from all supplies made by that company, or a connected company, to customers in the United Kingdom in a 12-month accounting period does not exceed £10 million. It is not clear from the words of the draft legislation whether it is the supply activity or the customer that has to be "in the United Kingdom" and, if the latter, what nexus is required in order for a customer to be "in the United Kingdom".

HMRC has indicated that the aim is to identify where the customers are located, and that this could be determined in accordance with generally accepted accounting principles with respect to geographic reporting (that is, reporting of operating segments or reportable segments). HMRC sees the sales threshold exemption as a filter for cases that would not present a significant risk in terms of sales into the UK market.

For the purpose of the exemption, "sales revenue" is intended to mean gross income, i.e. sales net of sales returns, allowances and discounts.

Investment Manager Exemption and Independent Broker Exemption

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

The IME is effectively a specific application, in the context of corporation tax, of the independent agent concept. This reflects the importance of the asset management industry to the UK economy and, as noted, is being carried across as an exemption from DPT. There is a parallel corporation tax PE safe harbour (again mirrored by a DPT exemption) for an independent broker.

HMRC Guidance

HMRC has published draft guidance on DPT, including examples of when DPT would apply.

Illustrative example: avoided PE

In terms of the first limb, draft HMRC guidance refers to "contrived arrangements used by large groups (typically multinational enterprises) that result in the erosion of the United Kingdom tax base." It states that this catches arrangements, involving significant sales activity in the United Kingdom, that are designed to stop short of the conclusion of contracts.

One example in the draft guidance describes a situation where a foreign company acquires widgets from a third party and sells them to customers in the United Kingdom and other markets. A UK company, which is a subsidiary of the foreign company, provides sales support services, such as identifying new customers and undertaking all selling activities to the point just before the conclusion of the contract with the customer. This last step is done by the foreign company, which is in a low-tax jurisdiction. There is no commercial reason why the contracts are not concluded in the United Kingdom except for the foreign company's imposing a restriction on the UK company.

HMRC comments that there is a contrived separation of the conclusion of contracts from the selling activity and process of agreeing terms and conditions. The requirement for the foreign company to conclude the contracts is deliberately intended to limit the activity that takes place in the United Kingdom. On this basis, HMRC concludes that a Section 2 DPT charge arises because the activities of both companies are designed to ensure that the foreign company is not carrying on a trade in the United Kingdom through a PE and the arrangements have a main purpose of avoiding a corporation tax liability, so the tax avoidance condition is met.

If the fees paid to the UK subsidiary for its sales support services meet the arm's-length standard, in accordance with international transfer-pricing guidelines, it is unclear from the HMRC guidance what proportion of the foreign company's profits will be subject to DPT.

Illustrative example: tax mismatch

With regard to the second limb, HMRC sets out an example where a parent company owns two subsidiaries, one in the United Kingdom and the other in a low-tax territory. The UK company needs to invest in new expensive fixed plant and machinery to carry on its trade in the United Kingdom. The parent company injects capital into its zero-tax subsidiary to enable it to purchase the plant and machinery. This is then leased to the UK company, so as to leave it with relatively small profits over a number of years. The zero-tax territory company has no full-time staff and the only functions it performs are to own the plant and machinery and to carry out some routine administration in relation to the leasing payments it receives.

HMRC comments that there is an effective tax mismatch outcome because the lease payments are allowable in the UK company's corporation tax computation but are not taxed in the hands of the zero-tax territory company. HMRC adds that the contribution by the offshore company's staff provides little economic value and that value is much less than the financial benefit of the associated tax reduction. Accordingly, HMRC concludes that it is reasonable to assume that the offshore company's involvement in the transaction was designed to secure the tax reduction.

HMRC goes on to say that DPT under the second limb would be calculated on the assumption that the UK company had instead acquired and owned the plant and machinery.

Pay Now; Argue Later

The assessment and charging procedures are novel.

Although DPT is not self-assessed, taxpayers are required to notify HMRC if it is reasonable to assume that they *might* be liable to DPT.

Tax must be paid within 30 days against an estimated tax assessment that is based on certain assumptions, such as a mandatory 30% disallowance of certain expenses that are suspected to be excessive.

The ultimate tax liability, after all the facts and arguments have been taken into account during a 12-month review period (and any subsequent appeal), may well turn out to be less than the original estimated amount that has been paid.

Critical Response

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, there is intense lobbying by business representatives and the tax advisory community to clarify and refine the scope of DPT.

The DPT regime may also come under international pressure. It is arguably incompatible with the UK's network of double tax treaties and/or the European Union freedoms.

Furthermore, the measure effectively jumps the gun on efforts by the OECD to coordinate multilateral action on international tax rules through the Base Erosion and Profit Shifting project (the **BEPS Project**).

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 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 first limb of DPT targets the same problem as is identified by BEPS Action 7 but, as outlined above, rather than widening the definition of PE, it seeks to tax directly certain activities in the UK that stop short of the current understanding of "permanent establishment".

In addition, on 19 December 2014, the OECD published a discussion draft on proposed revisions to internationally agreed transfer-pricing guidelines (BEPS Project Actions 8 to10). These include new clarification on the circumstances in which transactions that would not, or would only very rarely, occur between third parties, can be recharacterised for tax purposes. The methodology for calculating the taxable diverted profits under both limbs of

DPT, in cases where the "effective tax mismatch outcome" condition is met, anticipates a greater readiness on the part of tax authorities to de-recognise certain intra-group transactions for tax purposes.

Going Forward

There continues to be consultation by HMRC with the public, with respect to both DPT and the BEPS Project, to which taxpayers can still contribute.

In addition, all multinational groups with a UK nexus will need to monitor these new developments in the coming year, and, given the expected imminent introduction of the DPT regime, consider the impact on their tax affairs and plan accordingly.

In particular, groups should review any current arrangements with low-tax jurisdictions (i.e. where the tax burden is less than 80% of the corresponding UK tax charge) that directly or indirectly impact the level of UK tax liabilities, and then consider the evidence for all the non-tax related financial benefits of, and justifications for, those arrangements, the robustness of the transfer-pricing analysis, and the economic substance of the offshore operations in terms of the quality and quantity of local staff and their contribution to the generation of profits. An up-to-date advance pricing agreement with HMRC may reduce the practical risks.

HMRC is apparently expecting that DPT will drive changes in taxpayer behaviour (in terms of restructuring and/or greater transparency over the value chain) as much as producing tax revenues.

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.

5 February 2015