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The U.K. Diverted Profits Tax— Political But is it Practical?

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The U.K.'s new Diverted Profits Tax ("DPT") took effect on 1 April 2015. The final legislation was published on 24 March 2015, receiving Royal Assent on 26 March 2015.

The DPT is widely referred to as the "Google tax" and is seen as a reaction to increasing publicity surrounding global multinationals. The main objective of the DPT, according to the government, is to "*counteract contrived arrangements used by large groups (typically multinational enterprises) that result in erosion of the UK tax base.*" However, the legislation is wider and may catch more structures than expected.

The DPT is focused on two key scenarios where a diversion of profits may arise, subject to various conditions and exclusions:

- i. Where a foreign company avoids creating a U.K. permanent establishment with the purpose of avoiding corporation tax (see '**Avoidance of UK Permanent Establishment**'); and
- ii. Where a U.K. company, or foreign company with a U.K. permanent establishment, transacts with a connected person in a way which lacks economic substance and exploits a tax mismatch (see '**Lack of Economic Substance**').

It should be noted that the below summary does not do justice to the complexities of the DPT.

A "**tax mismatch outcome**" arises, broadly, where:

- i. the U.K. tax reduction derived from the arrangements by one party exceeds any increase in tax payable by the other relevant party to the arrangements; and
- ii. the tax payable by the other party is less than 80% of U.K. tax reduction derived by the first party.

"**Insufficient economic substance**" is considered to be present, broadly, where:

- i. it is reasonable to assume that the structure of the transaction(s) was created so as to reduce the tax liability of the foreign company; and
- ii. either:
 - a. the financial benefit of the decreased tax liability of the foreign company is greater than any other financial benefit; or
 - b. the contribution of economic value of the functions or activities of the staff of any party to the transaction(s) is less than the financial benefit of the tax reduction.

Avoidance of U.K. Permanent Establishment

The DPT will be imposed in this scenario where:

- i. a person (the "avoided PE") is carrying on an activity within the U.K., which is in connection with the supply of goods, services or other property by a foreign company in the course of its trade; and
- ii. it is reasonable to assume the arrangements are designed to ensure that the foreign company does not carry on that trade in the U.K. so as to create a U.K. permanent establishment; and
- iii. either:
 - a. arrangements have been put in place wholly or mainly for the purposes of avoiding or reducing corporation tax (note that it is irrelevant whether an alternative business objective exists alongside this); and/or
 - b. arrangements are in place between the foreign company and another related person that result in an effective "*tax mismatch outcome*" **AND** these arrangements have "*insufficient economic substance*".

The legislation was amended from its original draft to "put beyond doubt" that it may apply in the context of real estate transactions.

Lack of Economic Substance

The DPT will also be imposed where there is a U.K. resident company, or foreign company with a U.K. permanent establishment ("Party A"), with a provision made or imposed between itself and a connected person ("Party B") by a transaction (or series) (the "Material Provision") and the following conditions are met:

- i. the relationship between Party A and Party B satisfies the participation condition (*i.e.*, broadly that the relationship between the connected parties is such that one has direct or indirect participation in the management, control or capital of the other);
- ii. the Material Provision results in an effective "*tax mismatch outcome*" **AND** the relevant arrangements have "*insufficient economic substance*".

Situations Where the DPT Will Not Apply

The DPT will not apply in a number of circumstances including with respect to small and medium sized entities, companies with limited U.K. sales or expenses, where arrangements give rise to loan relationships only, and where certain statutory exemptions apply. Additionally, activities of agents of independent status and certain alternative finance arrangements may also fall outside the DPT.

Assessment

Companies must disclose to HMRC if they are potentially within the scope of tax within three months of the end of the relevant accounting period. In the final legislation, the government has clarified that where the accounting period ends on or before 31 March 2016, the notification period will be six months. This will however be shortened for accounting periods ending after 31 March 2016, when notification must be made within 3 months of the end of the accounting period.

Although one of the notification requirements has been narrowed such that companies will not need to notify where it is reasonable to assume that there will be no charge to DPT, (which was a welcome change from the original draft which required notification where it was reasonable to assume that diverted profits might arise), generally, the DPT notification provisions are very wide and will need to be considered very carefully. It should also be noted that there is a penalty imposed for failure to notify and many advisers will spend significant time determining whether there is a need to notify—they may choose to err on the side of caution.

HMRC will assess whether it will apply the DPT and, following a period where the company may make representations, will issue a charging notice. The DPT is due within 30 days of the charging notice being issued.

HMRC have confirmed that, where a company has previously notified HMRC that the DPT may apply, it will not be necessary to notify for any following accounting periods provided that the circumstances remain the same.

Pre-existing APAs which cover transfer pricing will not apply to the DPT, as it is a standalone tax, and companies should therefore engage with HMRC to consider the potential for a DPT notice being issued. The existence of an APA, even if entered into post 1 April 2015, will not prevent a charging notice being issued.

Calculation

The DPT rate is 25% (with an alternative 55% rate for oil and gas companies within the ring-fence regime), plus any "true-up interest" which is applied to the company's taxable diverted profits. However the exact mechanic for determining the quantum of a company's taxable diverted profits is complex and will vary depending on whether there is considered to be an avoided PE or lack of economic substance.

Whilst the legislation will broadly apply to attribute profits to the U.K. on branch attribution/existing transfer pricing principles, there will also be a need to consider and determine the relevant "alternative provision". Such "alternative provision" being that which it is just and reasonable to assume would have been made or imposed as between the foreign company and one or more companies connected with that company, instead of the material provision (*i.e.*, actual transaction/series of transactions), had tax (including non-U.K. tax) on income not been a relevant consideration for any person at any time.

Credit will be applied, in certain specified circumstances, where double taxation has occurred due to a foreign company paying corporation tax in its home jurisdiction or where tax is already paid on the profits subject to the DPT, *e.g.*, under controlled foreign company rules.

Practical Considerations

Transfer Pricing

There appears to be some similarity between this legislation and that of transfer pricing. The DPT will not generally apply where a complete transfer pricing adjustment has been applied. However, the application of the DPT is intended go further than transfer pricing and to catch those transactions where, even if arm's length prices have been in place, the arrangement lacks economic substance and has the intention of reducing the tax liability of the foreign company.

Real Estate

As mentioned above, the legislation has been drafted to make clear that it may apply to the sale of property. However, it is not clear how the legislation is to apply in practice and we think companies in the following scenarios should take particular consideration of the new legislation:

- Property development projects, organised so that U.K. property is owned offshore without a U.K. presence, should be reviewed in light of the legislation on avoided PEs.
- Companies where a propco/opco structure exists such that the opco leases the property from the propco and carries on the trading activity. These companies should ensure that, with the test for lack of economic substance in mind, they do not fall within the scope of the DPT.

Additional Issues

The U.K. is taking part in the Base Erosion and Profit Shifting ("BEPS") programme, designed to implement policies to tackle tax avoidance through international cooperation. The U.K. government has said that they remain committed to BEPS despite this unilateral action, but critics suggest that this legislation will affect the U.K.'s commitment to the programme and will erode cooperation by encouraging other jurisdictions to implement their own legislation.

HMRC's view is that the DPT falls outside of scope of the U.K.'s double tax treaties, as it is not an income or corporation tax, and so relief would not be available pursuant to any tax treaty currently in place. However, there may be an argument that where any treaty refers to corporation tax and "other similar taxes", the DPT could be caught and the government may face questions from tax treaty counterparties and taxpayers.

Finally, a concern remains that the DPT may be incompatible with the EU rights of freedom of establishment or the freedom to provide services.

HMRC has announced that it is working with five other tax authorities to share information about how digital multinationals might be shifting their profits to tax havens. It said that information from the 'E6 project' will feed into how HMRC applies DPT. It is not clear which other jurisdictions are involved.

As the DPT has imposed a notification deadline, it is essential that companies begin to assess immediately whether they may be affected by the DPT and seek appropriate advice we also await developments in other jurisdictions with baited breath.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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