SQUIRE PATTON BOGGS

UK'S DIVERTED PROFITS TAX
No April Fool

The UK's December announcement of a proposed new tax to counter perceived avoidance of tax by shifting profits out of the UK took the global tax world by surprise. From being an active participant in the OECD BEPS programme, the UK is now out in front, having taken direct action to tackle concerns about diverted profits and base erosion.

Speedy Implementation

The introduction of diverted profits tax (DPT) was reconfirmed in last month's Budget with the government sticking to a start date of April 1, 2015, despite protests that this did not give enough time for proper scrutiny or preparation. The legislation was rushed through days before Parliament was dissolved for the upcoming general election in May, relying on cross-party support.

Following the brief consultation process earlier in the year, there have been some changes to the scope and application of DPT compared to the original plans but the basic framework of the new tax remains largely unchanged. The projected revenues from DPT also remain modest – the real impact may be behaviour changes that increase other UK tax revenues.

How Does DPT Work?

DPT applies in two distinct situations:

- A non-UK business trades using a structure that, within currently accepted global tax rules, means it has no permanent establishment (taxable presence) in the UK. For example, current OECD guidelines focus on where contracts with customers are entered into – a common arrangement would require a UK-based sales force to pass all deals to an overseas team to be finalised and completed. The profit is then booked outside the UK and is not taxed in the UK. Under DPT, the non-UK business can be deemed, effectively, to have a UK permanent establishment and be taxed in the UK on all profits attributable to that permanent establishment, including those arising from transactions with non-UK customers. DPT is not chargeable if UK sales are below approximately US$15 million or UK costs do not exceed approximately US$1.5 million. The costs threshold is a welcome new feature that will assist businesses which, for example, send employees to the UK on a temporary basis to sign up UK customers.
- A UK company or a branch of a non-UK company carries on a trade in the UK, dealing with customers anywhere in the world, but buys in goods or services from a connected company – one example given by the government is licences of intellectual property. Existing transfer pricing rules mean that the arrangement between the two companies is taxed in the UK on an arm's length basis, reducing the scope to strip profits from the UK. DPT effectively extends the transfer pricing rules in two ways:
  - It allows the UK to take account of the fact that the non-UK counterparty is based in a low tax country; and
  - It allows the UK to look further up the supply chain and assess the overall tax outcome – this targets the so called "double Irish" structure where IP is licensed through a chain of group companies.

  The diverted profit is, broadly speaking, the profit that is not taxed in the UK as a result of the overall arrangements, after allowing for any adjustment made to the UK company's UK taxable profits under transfer pricing.

Exemptions

DPT will not be charged in every situation that fits these circumstances – there has, broadly speaking, to be a tax advantage that results in profits being taxed at a lower rate than they would be in the UK or a lack of economic substance to one of the entities involved in the overall arrangements (so that, for example, the non-tax benefits arising from involvement of the entity's staff do not exceed the financial benefit of the tax reduction). There have been detailed changes here to narrow the scope of the tax and better integrate it into existing transfer pricing rules.

There are new exemptions for charities, entities that benefit from sovereign immunity, pension funds and some widely owned investment funds. However, it is now clear that real estate transactions can be caught by DPT – Opco/Propco structures where land is owned outside the UK and leased to a UK affiliate may need to be reviewed.

Premium Rate of Tax

The rate of DPT has been fixed at 25% which is charged on the aggregate of the diverted profits plus interest running from three months after the end of the relevant accounting period or the date HMRC issue a notice that the company has a DPT liability. Credit is given for non-UK tax paid on the diverted profits to minimise the risk of double taxation but the 25% rate has been set at a substantial premium above the 20% rate for UK corporation tax to encourage businesses to restructure the way they operate. (A higher rate applies to profits generated from oil and gas production in the UK that are subject to the special higher tax regime for that industry.)

Self-notification of Potential Liability

There is a compulsory notification procedure for each accounting period where a DPT charge may arise. Notifications must be filed within three months of the end of the period, although for the first year this is extended to six months.

The obligation to notify is much more targeted than originally proposed but still merits careful consideration. Relatively few companies may find they need to make a notification but many more will incur time and expense reaching a decision that they are exempt from the requirement.

For example, notification is not required unless the financial benefit of the UK tax saving is significant relative to the non-tax benefits of the arrangements (working this out will not be an easy task). Further, notification is not required if it is reasonable to conclude that no DPT liability will arise or if the UK tax authorities have previously confirmed there is no liability (this at least avoids the need to make an annual notification).

The changes to the notification obligation are welcome but companies will still need to consider carefully whether they need to notify or not. A precautionary discussion with HMRC may well be advisable.

Compliance Procedure

Once a company has notified HMRC of its potential liability, the compliance procedure continues to be very different from the norm. The next step would be for HMRC to issue a "preliminary notice" that explains why HMRC consider a DPT charge arises. The company has 30 days to make limited representations to HMRC. Following that period, HMRC can issue a "charging notice" or confirm that no tax is due. The tax shown on the charging notice must be paid within 30 days (with interest). The company can then dispute the amount of tax but this will not defer payment.

Challenges

When DPT was first announced, strong views were expressed that the tax was inconsistent with the UK's obligations under double tax treaties and could breach the fundamental EU right of freedom of establishment. Time will tell whether legal challenges follow the issue of charging notices.

Another open issue is whether the Internal Revenue Service and other non-UK tax authorities will accept that a DPT charge gives rise to a foreign tax credit to eliminate potential double taxation of profits that have been subject to DPT in the UK.

Actions

Faced with a new tax that has been introduced with little opportunity to plan for, what can multinational businesses that trade with or in the UK now do? A first step is to consider whether they are vulnerable to a DPT charge. That may be easier said than done but will determine whether a notification of liability must be made in due course and whether existing business structures should be adapted. Compared to a 25% DPT charge, UK corporation tax at 20% may now seem more attractive – which is no doubt what the UK government hopes.

One final point to note. The UK has been actively participating in the OECD's current work on BEPS but has now introduced DPT before the OECD has completed its work. There may be advantages in being ahead of the game if other countries follow the UK's lead. But this risks each country adopting its own tax regime leading to a greater chance of double taxation of profits – or, of course, the UK may have to change DPT to align it with a globally agreed set of rules. Watch this space.

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