FA 2015 analysis

Diverted profits tax: an overview

SPEED READ The diverted profits tax is a new tax enacted as part of FA 2015. It seeks to target profits which have been 'diverted' from the UK tax net, either by the involvement of entities or transactions lacking economic substance, or through an 'avoided PE'. Taxable 'diverted profits' are assessed by HMRC issuing a charging notice, as opposed to under self-assessment, and are subject to tax at 25% (or 55% in the case of ring fence profits). The legislation is complex and its interaction with the UK's DTTs and EU law obligations, as well as the BEPS programme, is unclear.

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First announced in parliament as part of the Autumn Statement on 3 December 2014, the diverted profits tax (DPT) legislation went through a single iteration on 10 December 2014 before being re-released with FB 2015 on 24 March 2015. It became law with the granting of royal assent to FA 2015 on 26 March. Although an open day for interested parties was held by HMRC on 8 January, comments were invited only on the technical aspects of the legislation, and the revisions at FA 2015 – though largely welcome – therefore did not dilute the controversial nature of the tax. 'Interim draft guidance' was released on 30 March 2015 (www.bit.ly/1Hwp4Fa), revising the guidance that had been issued with the first draft of the legislation in December 2014. As has been stressed both inside and outside parliament during the passage of FB 2015, this legislation has been passed at speed. Given the volume of legislation and guidance that was produced in December, we may assume that DPT had already been under development for some time (and at least since the tax was hinted at during the Conservative party conference in September).

This article gives an overview of when DPT applies and how it is calculated, and of notification requirements and key administrative provisions, while summarising key developments from FB 2015 to FA 2015 and the accompanying guidance (together with the relevant statutory references given its recent implementation). It concludes with a brief discussion of points of interest from the perspective of BEPS, the UK's double tax treaty (DTT) network and EU law.

Charging provisions

Companies may be subject to DPT where they are involved with transactions or entities lacking economic substance (ss 80 and 81) or which avoid creating a UK permanent establishment (PE) (s 86).

Transactions or entities lacking economic substance: Section 80 applies to a company (C) in an accounting period if:

- it is UK resident;
- provision (the 'material provision') has been made between it and another person (P) by means of a transaction or series of transactions;
- C and P are connected under the 'participation condition';
- the material provision results in an 'effective tax mismatch outcome';
- the effective tax mismatch outcome is not an 'excepted loan relationship outcome';
- the 'insufficient economic substance condition' is met; and
- C and P are not both SMEs (within the meaning of TIOPA 2010 s 172).

Section 81 extends s 80, applying it to a foreign company if it carries on a trade in the UK through a UK PE (also called C), which is then treated as a UK resident company under the foreign company's control.

Sections 80 and 81 therefore hinge upon several concepts that require examination.

Transaction or series of transactions: The revised guidance indicates that 'transaction' and 'series of transactions' have the meanings given in the transfer pricing rules at TIOPA 2010 Part 4. Consequently, a series of transactions does not require that two persons are party to the same transaction; the guidance extends the phrase to include arrangements 'through a series of transactions some of which may involve third parties' (see para DPT1115 of HMRC's interim guidance referred to above).

Participation condition: The participation condition in s 106 requires C to be 'directly or indirectly participating in the management, control or capital' of P (or vice versa); or for the same person to do so in respect of both C and P. 'Direct' and 'indirect' participation are also read by reference to transfer pricing legislation. The participation condition generally considers the position at the time the material provision was made or imposed, but is extended to the following six months where financing arrangements are made.

Effective tax mismatch outcome: Reading references to the first party as C and the second party as P, there is an effective tax mismatch outcome under s 107 if the material provision results in:

- allowable expenses of the first party for a 'relevant tax' (CT on income; an amount payable under the supplementary charge in respect of ring fence trades; and IT or non-UK tax on income) and/or a reduction in income that would have been included in computing liability for a relevant tax;

- a reduction in the first party's liability to a relevant tax exceeding any resulting increase in relevant taxes payable by the second party;
- such expense or reductions not being 'exempted' (see below); and
- the increase in the second party's liability to relevant taxes not being at least 80% of the reduction in relevant tax payable by the first party (HMRC considers that this test ensures DPT applies only if tax reductions resulting from the material provision are substantial).

It should be noted that a mismatch could occur even if the first party does not save tax, e.g. because it is already in a loss making position before any deduction for a payment takes place. However, as noted later, this should mean that no actual liability arises under the calculation provisions.

Broadly, results or expenses are exempted if they arise from contributions paid by an employer under a pension scheme, or payments to:

- a charity;
- a person that is tax exempt by reason of sovereign immunity; or
- an offshore fund or authorised investment fund meeting a diversity of ownership condition or where at least 75% of its investors are certain tax exempt persons.

The exempted transactions list was only added in the FA draft. The revised guidance explains that if HMRC considers that exemptions are exploited to facilitate profit diversion, 'HMRC will seek to deny the benefit of the exemption, including where appropriate through use of the General Anti-Abuse Rule (GAAR)' (DPT1180).

Insufficient economic substance condition: Per s 110, this condition can be met if it is reasonable to assume:

- the transaction or series of transactions was designed to secure the tax reduction, unless at the time of the material provision being made it would be reasonable to assume that the 'non-tax benefit' would be greater than the financial benefit of the tax reduction for C and P over the course of the transaction; and/or
- the involvement of a person was designed to secure the tax reduction, unless: (i) a modified version of the 'reasonable to assume' test above applies; or (ii) a majority of the income attributable to the transaction(s) in the relevant accounting period is attributable to ongoing functions or activities of the person's staff.

Excepted loan relationship outcome: An effective tax mismatch outcome will be an excepted loan relationship outcome per s 109, if arising wholly from:

- anything that, if a company within the charge to CT were party to it, would produce debits or credits under CTA 2009 Part 5; or
- a loan relationship and a derivative contract only entered into to hedge risk in connection with that loan relationship.

HMRC's revised guidance clarifies that loan relationships producing an effective tax mismatch outcome do not automatically except the outcome. Rather, the effective tax mismatch outcome must *arise wholly* from the loan relationship/hedging contract (DPT1110).

Avoidance of UK taxable presence: Section 86 applies to a company (the 'foreign company') for an accounting period if during that period:

- it is not UK resident;
- it carries on a trade;
- in connection with supplies of goods, services or other property made by it in the course of its trade, another person (the 'avoided PE'), whether or not UK resident, carries on an activity in the UK;
- s 87 (exception for companies with limited UK-related sales or expenses) does not apply;
- it is reasonable to assume that any activity of the avoided PE, the foreign company or both is designed to ensure that the foreign company does not, as a result of the avoided PE's activity, carry on a trade in the UK for CT purposes (whether or not also designed to secure any commercial or other object);
- the 'mismatch condition' (similar to the rule in ss 80 and 81), 'tax avoidance condition', or both, are met;
- the avoided PE is not excepted by s 86(5); and
- both companies are not SMEs.

Again, several concepts require further examination.

Goods, services or other property: The original draft legislation required there to be a supply of services or goods as a result of UK activity. The FA now applies the s 86 charge to supplies of 'other property', which is clearly designed to catch a very wide range of activities carried on in the UK, including real estate transactions.

Section 87 (exception for companies with limited UK-related sales or expenses): Section 87 disapplies s 86 in respect of the foreign company for an accounting period where it has (including any connected companies):

- sales revenues from 'UK-related supplies' (supplies of goods, services or other property that relate to 'UK activity') no greater than £10m; and/or
- expenses relating to UK activity which are no greater than £1m.

'UK activity' means activity carried on in the UK in connection with supplies of goods, services or other property made by the foreign company in the course of its UK trade. Whilst the sales revenue exemption is helpful, it does not appear at first glance that the expenses threshold will assist many.

The tax avoidance condition: Section 86(3) provides that this condition is met if, in connection with the avoided PE's activity, arrangements are in place, one of the main purposes of which is avoiding or reducing a CT charge.

What is meant by 'main purpose' or 'one of the main purposes' is not defined. HMRC's revised guidance indicates that these expressions are given their 'normal meaning as ordinary English words. They have to be applied objectively, having regard to the full context and facts' (DPT1150). Further, HMRC 'would seek to apply this rule if the company has put in place arrangements that separate the substance of its activities from where the business is formally done, with a view to ensuring that it avoids the creation of a UK PE and it is clear that doing so has resulted in a tax saving'.

Excepted PEs: An avoided PE is 'excepted' under s 86(5) if:

- it is an 'agent of independent status' or party to an 'alternative finance arrangement' under CTA 2010 ss 1142 or 1144, and therefore the foreign company would not be treated as carrying on a trade in the UK; and
- it and the foreign company are not connected in the relevant accounting period, unless it is regarded as an agent of independent status by virtue of the independent broker, independent investment manager or Lloyd's agent provisions of CTA 2010 ss 1145, 1146 and 1151.

Calculating diverted profits

Different methods apply for calculating taxable diverted profits under ss 80 and 81 and under s 86. Profits are estimated when issuing a preliminary notice or a charging notice in a way that is different (see below).

Calculating taxable diverted profits under ss 80 and 81: Taxable profits of a company (or in the case of s 81, a UK PE) are calculated in respect of ss 80 and 81 in one of the following three ways:

- Under s 83, no taxable diverted profits arise if the 'actual provision condition' is met and there are either no diverted profits, or there are diverted profits but the company has made the 'full transfer pricing adjustment', so that all diverted profits (defined here as amounts resulting from a material provision for which the company is subject to CT under the transfer pricing rules) have been taken into account in calculating CT due.
- If the actual provision condition is met, but s 83 does not apply (e.g. because the company has not made the full transfer pricing adjustment), s 84 calculates taxable diverted profits as amounts chargeable to CT after applying transfer pricing, but which were not in fact taken into account in assessing CT. Adjusting CT returns in time may therefore reduce any DPT charge under this head.
- Per s 85, if the actual provision condition is not met, taxable diverted profits are determined by reference to the relevant alternative provision rather than the material provision.

Per s 82(7), the actual provision condition is met if: (i) the material provision results in deductible expenses for the company (ignoring transfer pricing adjustments); and (ii) the 'relevant alternative provision' would have resulted in deductible expenses of the same type as (i), so there is an effective tax mismatch outcome, but no taxable income of a connected company.

The relevant alternative provision per s 82(5) is the provision that it is just and reasonable to assume would have been made instead of the material provision, if tax on income were not a relevant consideration for any person at any time.

Calculating taxable diverted profits under s 86: The FA does not differ greatly from the initial draft in calculating s 86 profits, but sets out more clearly the three ways in which taxable diverted profits can be determined (ss 88–91):

- Where only the tax avoidance condition (and not the mismatch condition) is met, s 89 results in taxable diverted profits being equal to notional profits of the avoided PE. Effectively, these are the profits that would be taxable if there were an actual PE, as calculated under CTA 2009 ss 20–32.
- Where the mismatch condition is met but profits are calculated by reference to the actual provision (because the material relevant alternative provisions would have resulted in expenses of the same type and not relevant taxable income), s 90 also results in taxable diverted profits being equal to the notional profits of the avoided PE.
- Where the mismatch condition is met but the actual provision condition is not met, s 91 requires taxable diverted profits to be calculated by reference to the relevant alternative provision. If the relevant taxable income would have resulted under the relevant alternative provision (and so the actual provision condition does not apply), this is added to the notional PE profits to obtain diverted profits. Otherwise, the taxable diverted profits are the sum of the relevant taxable income and the notional profits of the avoided PE, had the relevant alternative provision been made instead of the material provision. This is expected to cause significant issues for taxpayers, save for very straightforward cases, as it is debatable what the alternative provision would be (particularly given the different ways to assess contributions by staff and non-tax benefits).

Credit for tax already paid: A regrettably vague 'just and reasonable' credit may be given under s 100 for CT or equivalent tax in another jurisdiction, calculated by reference to the profits of the company. Although credit provisions in the FA now include credit for any UK CFC charge (or foreign equivalent), no credit is given for any IT paid on the relevant profits, leaving open the possibility of double taxation.

An unwelcome change is that no credit is given for tax paid after the end of the review period for the charging notice, potentially leading to unfair disallowance of credit, given the different reporting regimes and timetables of DPT and CT.

Notification requirements

The broad scope of DPT notification requirements in the initial draft legislation has been substantially curtailed. Notification is now required if any of ss 80, 81 or 86 apply, each to be read with some modifications and – save where s 86 applies as a result of a (modified) version of the tax avoidance condition – where the tax reduction for the period is 'significant' in relation to the non-tax benefits. Unfortunately, neither the initial nor the revised guidance explores the meaning of 'significant'.

The modifications mentioned above increase the scope of ss 80, 81 and 86 by removing the insufficient economic substance condition. In addition, for notification purposes: (i) s 86 tests whether the foreign company *is* outside the scope of CT as a result of the avoided PE (rather than whether arrangements are designed to achieve this); and (ii) the tax avoidance condition looks at whether the result, as opposed to the main purpose, of the arrangements is a tax reduction.

New exclusions from notification apply under s 92(7), (8) where:

- it is reasonable to conclude that no DPT will arise, ignoring future transfer pricing adjustments;
- HMRC has confirmed, or it would be reasonable to conclude, that no notification is needed because sufficient information has been provided to determine whether a preliminary notice is needed, and this information has been reviewed by HMRC in relation to DPT or otherwise;
- notification was given in the immediately preceding period, or not required because of the 'sufficient information' exclusion, and it is reasonable to conclude there was no change which would be material to whether a charge would be imposed; or
- HMRC directs that the duty to notify does not apply.

It is unclear how much information would be 'sufficient', and in particular whether advance pricing agreements (APAs) would qualify. (Although the revised guidance discusses at DPT1700 how 'APAs in force at 1 April 2015 interact with DPT', this point is not discussed.) A further ambiguity is whether '*immediately* preceding' periods in the third exclusion are mentioned, because notification, confirmation of no notification needed, or sufficient information is given to HMRC every other year.

Despite a query on the point during the Westminster Hall DPT debate (*Hansard*, 7 January 2015, col 83WH), there is no formal clearance mechanism. While HMRC has informally indicated that, post 1 April 2015, APAs may be regarded as de facto DPT clearance, neither legislation nor guidance confirms this point (assuming full disclosure of the relevant facts). The non-statutory clearance mechanism, formerly CAP1, seems to be excluded by DPT1640 of the revised guidance (which states 'HMRC will not provide formal or non-statutory clearances in respect of DPT'); this also indicates that no advance view may be given in some cases and that HMRC does not intend to agree APAs where arrangements are liable to DPT.

Notification must be made in writing within three months of the end of the relevant accounting period. This is softened in the FA, by giving companies with periods ending before 1 April 2016 six months to notify. The information to be provided under s 92(1) is supplemented in DPT2050 of the revised guidance by details of where to send notifications and a notification template.

Estimating diverted profits

When issuing preliminary or charging notices, diverted profits are calculated 'on the basis of the best estimate that can reasonably be made at that time' of the amount calculated as described above (ss 96(2) and 97(2)). Clearly, as HMRC determines this amount, it has wide discretion where only limited information is available.

Additional steps are taken under ss 96(4) or 97(4) for estimating profits if the 'inflated expenses condition' is met, i.e. if:

- the mismatch condition is met;
- the arrangements result in deductible expenses; and
- the expenses result in the mismatch.

If relevant expenses are considered by HMRC to be greater than arm's length equivalents, they are reduced by 30% (ignoring transfer pricing) at this stage.

The revised guidance states that where a company has already made transfer pricing adjustments, 'any reduction in the amount of the deduction would be taken into account in applying the 30% reduction but not so as to reduce the amount below nil' (DPT1139).

Since DPT is aimed at large MNEs, it seems likely they would have robust policies in place, and therefore that HMRC would agree that the 30% reduction should not be applied.

It is unclear how this will be taken into account at preliminary/charging notice stages unless HMRC has already received a transfer pricing analysis, since transfer pricing is not an area in which representations may be made at this stage by taxpayers.

Administrative provisions for charging companies

Unlike notification requirements, the initial calculation provisions were relatively lightly amended in the FA. If ss 80, 81 or 86 are believed to apply, HMRC issues a preliminary notice under s 93, setting out the basis for calculation of the proposed charge. HMRC has two years from the end of the relevant accounting period to produce this notice where duly notified, and four years otherwise.

Section 94 gives companies 30 days beginning with issue (as opposed to receipt, in the FB) of the notice to send written representations, only on:

- arithmetical error;
- the SME condition not being met;
- in the case of ss 80, 81, or where s 86 is said to be met as a result of the mismatch condition: the participation condition test is not met, the 80% payment test is met, or the effective tax mismatch outcome is an excepted loan relationship outcome; or
- in a s 86 case, the exception for companies with limited UK-related sales or expenses applies, or the avoided PE is excepted.

The revised guidance summarises these as 'factual matters that it should be possible to establish relatively quickly' (DPT2100). It is hoped that other similar errors which are not included in the list might also be considered at this stage.

Thirty days after the period for taxpayer representations, HMRC decides whether to issue a charging notice (supplying designated information) or to notify that no notice pursuant to that preliminary notice will be issued. It is possible for a subsequent preliminary notice to be issued. Per s 98, DPT is to be paid within 30 days of issue of the charging notice; 'payment of the tax may not be postponed on any grounds'. The amount charged is then reviewed under s 101 in light of the full provisions for calculating diverted profits. An amending notice or supplementary charging notice may then be issued. In what appears to be an oversight, s 100 (dealing with credits against DPT for other taxes) is not included in the list at s 101(3) of sections which HMRC must consider when ascertaining whether DPT is finally due.

BEPS/DTTs

The chancellor stated in a March 2014 document discussing BEPS that 'international cooperation is the only way to tackle the challenge of tax avoidance in the global economy' (www.bit.ly/NSzEha) and, given the UK's general support for BEPS, it is surprising that it has now sought to pre-empt any outcome with unilateral action. It should also be noted that DPT conflicts with issues addressed by BEPS, such as by incorporating transfer pricing guidelines which are currently the subject of work by the OECD (www.bit.ly/1uBd7uc), as well as affecting the issues being considered on CFCs, information disclosure, IP, hybrids and PEs. Moreover, if the OECD work on BEPS is successfully completed and implemented, then arguably DPT would not be necessary and one could envisage a situation where DPT is eventually withdrawn. This brings into question the timing of DPT and whether its introduction could have waited.

The biggest risk, however, may be that other states decide to follow the UK's lead, leaving the international tax landscape littered with derivative DPTs. It has, for example, been reported that Australia is considering enacting its own version of DPT, albeit that a government body has recently advised against this for reasons similar to DPT criticisms expressed in the UK. A number of measures all circumventing treaty obligations could lead to international tax law reverting to a situation effectively without treaties, exposing taxpayers to the double taxation and other uncertainties which treaties are designed to relieve.

The interaction of DPT with DTTs continues to prove a contentious issue. HMRC appears to be of the following view:

- DPT is neither expressly covered by DTTs, nor a 'substantially similar' tax. Similarly, as actual profits are not taxed but an artificial amount is calculated by reference to profits, treaty benefits do not apply (c.f. *Bricom Holdings Ltd v CIR* (1997) 70 TC 272).
- The OECD commentary does not require states to grant treaty benefits in abusive situations; the 1969 Vienna Convention on the Law of Treaties requires treaties to be interpreted in 'good faith'.
- Tax treaties are only given effect to the extent they do not conflict with UK law (c.f. TIOPA 2010 ss 2 and 6). No treaties have been given effect in respect of DPT; therefore relief from DPT is not part of UK law.

The lack of similarity of DPT to CT and IT is debatable. For instance, calculation of DPT requires the application of transfer pricing principles, and profits taxed by DPT are essentially those which should, in HMRC's view, be subject to CT – reflected by the fact that credit may be given against CT paid. Further, the deliberate engineering of DPT as a new tax for the purposes of sidestepping the UK's DTT obligations itself smacks of artificiality.

Moreover, the descriptions of taxes covered in UK DTTs vary widely but a number of them apply to CT, IT and 'other similar taxes'. The UK/US DTT, for example, applies to 'taxes on income and on capital gains imposed on behalf of a Contracting State irrespective of the manner in which they are levied'. The treaty applies to 'any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes'. One could argue that DPT is a 'substantially similar' tax to those listed.

It is also not necessarily the case that a transaction that is caught by DPT is in fact 'abusive' or relies on an interpretation of treaties which is not in 'good faith'. It is quite possible that HMRC itself will have cleared transactions which relied on DTTs or an APA, but which it now considers subject to DPT.

The third point is reminiscent of *Collco Dealings Ltd v IRC* (1961) 39 TC 509, a case in which an Irish resident company argued that an exemption from IT under the UK/Ireland DTT should apply to an abusive scheme, which parliament had legislated against by denying the relevant advantage to 'a person entitled under any enactment to an exemption from income tax'. The taxpayer appealed to 'the comity of nations and the rule of international law' as grounds for reading a specific exception into the statute for treaty rights. While acknowledging the presumption that parliament does not intend to infringe the comity of nations, the court rebuffed the company's argument, broadly on the grounds that as parliament's will is supreme, the treaty only had life to the extent that parliament wished – and it was clear that it did not wish that to be the case.

Whatever interpretation the courts give DTTs in the context of DPT, it is regrettable that the UK has chosen to sidestep bilaterally negotiated rights. The government's approach also raises questions about whether DPT (if outside the scope of DTTs) would be a creditable tax for foreign entities. More generally, it is unclear whether the UK itself is acting in accordance with the principles at arts 26 and 27 of the Vienna Convention, that every 'treaty in force is binding upon the parties to it and must be performed by them in good faith' and that a 'party may not invoke the provisions of its internal law as justification for its failure to perform a treaty'.

Further to the TIOPA 2010 provisions mentioned above, taxpayers can only enforce rights or challenge improper performance of treaty obligations in the UK courts to the extent that they have been implemented into domestic law (save perhaps to a limited extent on legitimate expectation grounds).

Therefore, it appears likely that were any challenge to be made under existing DTTs, it would need to be made by affected contracting states. The US, with a DTT which applies to 'substantially similar' taxes, may be a possible candidate given that many of the intended targets of DPT are US MNEs, but we shall see. At the time of writing, we also understand that the IRS is yet to formally confirm that it considers DPT to be creditable against US taxes.

EU law

DPT's interaction with freedoms of establishment and of provision of services granted by arts 46 and 59 of the Treaty on the Functioning of the European Union (TFEU) is similarly uncertain and could form the basis for its own article (or thesis!).

HMRC's principal response has been and will likely be that, as a measure dealing with tax avoidance, any restriction on freedoms is justifiable and proportionate. Although the CJEU has recognised combating tax avoidance as justification for restrictive legislation, notably in *Cadbury Schweppes* (C-196/04) and *Thin Cap GLO* (C-524/04), the fact that DPT may apply to arrangements that are not wholly artificial and have commercial, non-tax purposes diminishes these arguments. It is also arguable that the modifications made in the FA which are intended to more precisely target artificial arrangements may put DPT at less risk of a challenge on the basis of this line of cases.

Additionally, the CJEU has previously held legislation that does not provide legal certainty to be unlawful, in particular in *SIAT* (C-318/10) and *Itelcar* (C-282/12). Legal certainty demands, per *SIAT*, that 'rules of law must be clear, precise and predictable as regards their effects, in particular where they may have unfavourable consequences for individuals and undertakings'. This objective is arguably not met by DPT because of its reliance on imprecise concepts such as whether it is reasonable to assume a particular fact, the fact that the amount due may not be determined for several years and the lack of an ability in the legislation to fully engage with HMRC or contest the charge at any stage before paying.

At the time of writing, we understand that the European Commission is considering DPT and its compatibility with EU law, though when and how it might respond are currently not known.

Conclusion

Given the various issues outlined above, it is difficult to consider that DPT is anything other than a knee jerk reaction by the current government to adverse publicity. If BEPS is indeed to be the panacea of international tax arbitrage, then DPT is a bit like a disease with no cure.

Points raised in previous articles on issues such as upholding the concept of the rule of law and not further eroding the lines between avoidance, abuse and evasion are relevant here. You do wonder, though, whether DPT would have been rushed through were it not for the recent press coverage on multinational tax affairs and tax's increasing prominence as a topic in the lead-up to the general election. This seems an ill-considered way to legislate and the related uncertainty can only hurt investment into the UK. ■

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