KPMG

Diverted Profits Tax

Updated HMRC Guidance

January 2016

Contents

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Speed read

Diverted Profits Tax (DPT) has been in force since 1 April 2015. DPT aims to tax profits which would otherwise not be subject to UK corporation tax, but which can be regarded as having been diverted from the UK tax base.

On 30 November 2015, HMRC published revised DPT Guidance (replacing the Interim Guidance issued in March 2015). The Guidance has been largely rewritten and provides good insights to how HMRC intends to apply and operate DPT.

Some key points arising from the Guidance are:

1) For DPT to apply, there has to be an element of contrivance- something has been done differently from how it would have been done but for a tax motive;

2) HMRC has views on what can be regarded as contrived which may surprise some companies;

3) Regardless whether companies decide they need to notify HMRC that they are potentially within the scope of DPT, HMRC will be conducting its own review of companies they consider may be liable to pay DPT; and

4) In conducting such reviews, HMRC will also be looking for tax exposures in relation to periods before 1 April 2015, for example in relation to undeclared permanent establishments or transfer pricing.

Detailed overview

As noted above, DPT applies, very broadly, in two main sets of circumstances:

Sections 80 and 81 Finance Act 2015 – where (a) the income of a UK company or UK permanent establishment is reduced as a result of arrangements (the "material provision") that result in income being diverted to another person that is effectively taxed at less than 80% of the relevant UK rate, and (b) it is reasonable to assume that the transaction itself, or the involvement of the other person, are designed to secure the corresponding UK tax reduction (condition (b) is referred to as the Insufficient Economic Substance Condition (IESC));

Section 86 Finance Act 2015 – where there is a person (company or individual) carrying on activity in the UK "in connection with" a trading activity (supplies of services, goods or other property) carried out by a foreign company, and it is reasonable to assume that the arrangements are designed to ensure that the foreign company does not have a UK permanent establishment (as defined in UK domestic law or in a relevant treaty).

HMRC's interpretations of the various terms used in these definitions has been further clarified in the Guidance and a summary of the key points is set out below (references are to the paragraph numbering in the Guidance).

'Reasonable to assume' test

The Guidance confirms that the "reasonable to assume" tests in both sections 80/81 and section 86 imply an element of contrivance. Specifically, for sections 80/81 to apply, the arrangements must differ in some material way from those which would have been made but for the opportunity to achieve a tax saving (DPT 1190). For example, in relation to an arrangement where ownership of intangible assets has been transferred from a UK company to a group company subject to a lower tax rate, some key factors to consider will be (DPT 1370):

— The use of the IP in the UK compared with use in other parts of the world;

— Whether there has been a separation of ownership from the functions needed to properly manage the asset, and, if so, the extent to which those functions are performed in the UK;

— Cost synergies of using the centralisation model;

— Extra costs associated with the transfer, including exit taxes;

— Whether, had the assets remained in the UK, tax depreciation would have been available;

— Any cost/ benefit analysis produced.

Similarly, in relation to section 86, for it to be reasonable to assume that the arrangements are "designed" to ensure the foreign company has no UK taxable presence, the arrangements must differ in some material way from those that would have been made had there been no consideration around the PE threshold (DPT 1140).

Sections 80/81: Effective Tax Mismatch Outcome and Qualifying Loss Relief

For sections 80/81 to apply, a necessary though not sufficient condition is that there be an Effective Tax Mismatch Outcome (ETMO). Broadly, there is an ETMO where the increase in tax payable by the related company to which income is diverted is less than 80% of the UK tax reduction (and the UK tax reduction is calculated by applying the statutory UK corporation tax rate to the relevant income/ expenses, regardless whether, for example, the UK company has tax losses or other attributes that would have in any event sheltered its UK tax liability).

The increase in tax payable by the foreign company is calculated after deducting any expenses or losses available to it, other than 'qualifying deductions' and 'qualifying losses'. So, for example, a payment to a company even in a high tax country may give rise to an ETMO if the foreign company can offset deductions or losses that are not 'qualifying'.

'Qualifying' deductions are those that do not arise directly from the making of the provision, and are of a kind that would have been deductible if incurred by the UK company or PE. Similarly, 'qualifying' losses are those that can be used for UK corporation tax purposes ('relevant CT loss') as well as, in the case of a non-UK company, 'any corresponding means by which a loss corresponding to a relevant CT loss' might be used for the purpose of the foreign corporate income tax.

The Guidance indicates that the effect of these rules is to give a consistent comparison between the tax positions of the two parties, so, for example, where a loss can be used for the purposes of the tax rules in the country to which income is diverted, but not in the UK, the loss will not be a qualifying loss. So, for example, there will be an ETMO where the foreign company can set off its profits against brought forward losses of other companies under the relevant country's tax consolidation system (DPT 1183). So for example, there will be an ETMO where profits are diverted to a US company whose profits are set off against other US group companies' brought forward losses under US consolidated tax return rules, because the same would not be possible under UK group relief rules.

Sections 80/81: Amount subject to DPT – interaction with transfer pricing rules

Where there is an ETMO, the IESC is satisfied, and none of the exemptions apply, DPT may be due on 'taxable diverted profits'. These are computed by first identifying the 'Relevant Alternative Provision' (RAP), i.e. the provision that would have been made had tax (including non-UK tax) not been a relevant consideration for any person at any time, and then determining whether the 'Actual Provision Condition' (APC) is satisfied. The APC is satisfied if, broadly, the actual arrangements (the 'material provision') result in a deductible expense, and the RAP would also have resulted in deductible expenses of the same type and for the same purpose as the actual expenses.

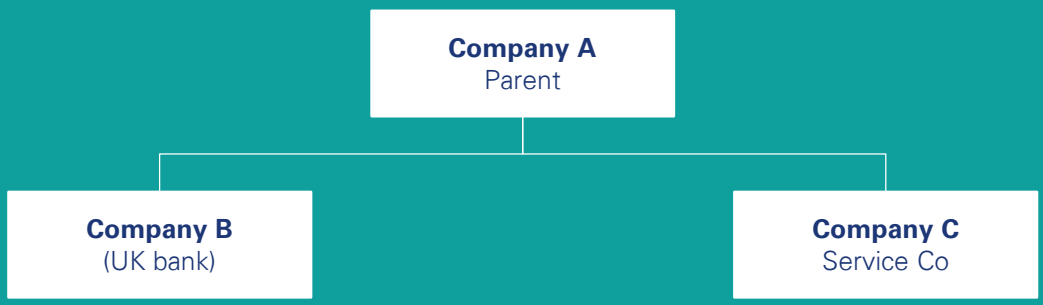
The guidance confirms that, if the APC is satisfied, then there are no taxable diverted profits provided either the actual transactions are at arm's length, or the required transfer pricing adjustment is made within 12 months plus 30 days of the issue of a DPT charging notice (DPT 1134).

As an example, the Guidance gives the case of a UK company paying royalties for the use of IP to an affiliate resident in a low tax territory, that has little functional substance. If all functions around development, enhancement and exploitation of the IP would have been carried out by other non-UK group companies, although there may be some doubt over the exact form of the RAP, in this case it would have resulted in the UK company making payments of the same type and for the same purpose as the actual payments. The APC is therefore satisfied and the only issue is whether the royalty payments are at arm's length.

By contrast, where the APC is not satisfied, then, broadly, the taxable diverted profits are the additional profits that would have been taxable in the UK had the RAP been made instead of the material provision. In such a case, there may be taxable diverted profits even if the material provision is priced at arm's length (DPT 1138).

As an example, the Guidance gives the case of a UK company which pays a royalty to a subsidiary in a low tax jurisdiction for the use of an asset. If the RAP would have resulted in the UK company holding the asset itself, no royalty would have been paid, therefore the APC does not apply. The diverted profits are therefore the amount of the royalty payment, regardless whether the royalty amount is at arm's length.).

Illustration 1 – Shared services centre

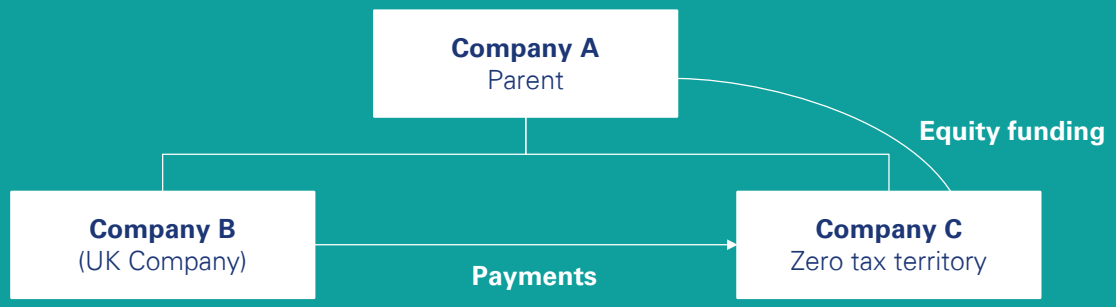


- As part of a 'recovery and resolution' plan, a banking group places crucial back-office shared services into a separate service company ('C') that are of high value and performed by staff in the jurisdiction of C.
- The transaction that could be considered to give rise to an ETMO is the contract under which C provides services to company B. However, the HMRC view is that in this scenario there is no contrivance and it is not reasonable to conclude that the transaction itself was designed to secure a tax reduction.
- The staff in C are undertaking high value roles in providing the services and it may not be reasonable to assume that its involvement was designed to secure the tax reduction.
- The IESC is not met and therefore DPT will not apply.

Illustration 2 – Foreign company investing in UK real property

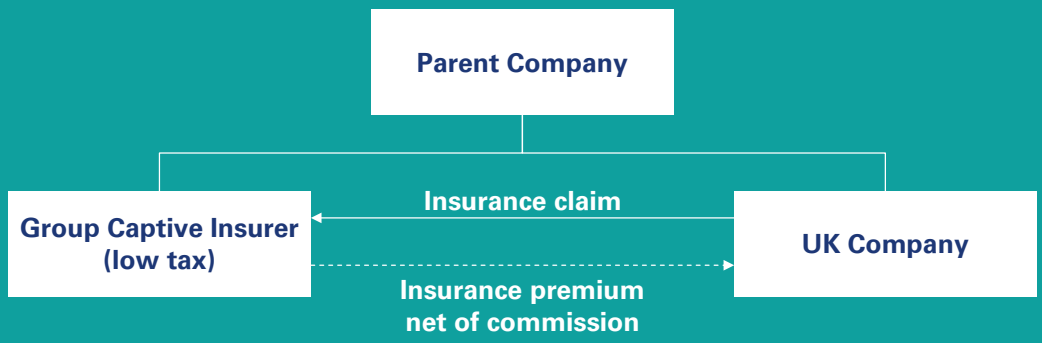
- A UK company which has traditionally held and managed all its property assets onshore sets up a company ('J') in a low tax jurisdiction, the management of which have limited expertise in property management. Ownership of a UK property that is in the course of development is subsequently transferred to J.
- All development costs are incurred by J but all development work and critical decisions are undertaken by the management team for the group in the UK.
- Upon completion of the development, the property is leased back to a property subsidiary in the UK and then on-let to tenants which the UK group finds for the property.
- The HMRC view is the RAP may well be that the asset would have remained in the UK, with no rental payments being made.
- It may be the case, where income tax is payable on the rental income (including tax withheld under the Non-Resident Landlord Scheme) there is no UK tax saving and no ETMO.
- By implication, however, if, for example, J was leveraged and the financing costs that are deducted under UK income tax rules would not have been an allowable deduction for corporation tax purposes (e.g. because of the unallowable purpose rule in s441 CTA 2009), there may be an ETMO and DPT may apply, with taxable diverted profits equal to the gross rental income.

Illustration 3 – Equipment Leasing



- B requires new fixed plant and machinery (P&M) for use in its trade in the UK and negotiates the contractual details with the supplier.
- A equity funds C (based in a low-tax jurisdiction), enabling it to purchase the P&M. C subsequently leases the P&M to B.
- C has no full time staff nor performs any functions apart from routine administration in relation to the leasing payments it receives.
- As C is in a zero tax territory, there is clearly an ETMO as a result of the material provision, the operating lease, between B and C.
- HMRC say that, depending on the facts and circumstances, in this case it may be reasonable to assume that both the transaction and the involvement of C are designed to achieve a tax reduction and that the RAP would be that B would have purchased and owned the P&M itself.
- Given that C has no financing expense, HMRC consider that there would be no reason to assume any for B, but they may accept that capital allowances would have been available.
- Accordingly, the taxable diverted profits subject to DPT would be the lease payments (even if arm's length), less the notional capital allowances that could have been claimed by B.

Illustration 4 – Captive Insurance Companies



— A multinational group manufactures specialist high value plant in a number of European countries. Failure of its product can give rise to significant catastrophic loss, however the group maintains excellent quality control and hasn't had a customer claim in the last 15 years.

— The parent company has oversight of group risk and determines the insurance policy for the group. It negotiates a group-wide insurance policy for product indemnity. The parent has determined that cover should be extended beyond the current cover limit and the excess is placed with the group's captive insurance company, established in a low tax jurisdiction.

— The captive employs three people part time including a senior underwriter. Most of the underwriting and actuarial risk pricing is outsourced to a specialist insurance consultancy based in the USA. The independent specialist insurance consultancy has produced a full actuarial report on the risk assumed by the captive. The insurance premium is paid at the arm's length rate.

— The captive does not reinsure its risks externally.

— The HMRC view is that, in these circumstances, the functions performed by the captive are minimal, and, although the premium paid may be correctly priced, it appears there are no commercial motives for the transaction other than the tax saving. As the captive has not insured its risk externally, it is reasonable to assume that the UK company could keep the risk on its own balance sheet.

— It follows that, absent the tax mismatch, the insurance would not have been arranged. The result is that the Insufficient Economic Substance Condition is likely to be met, the APC is not met and the likely result is that the UK company will be subject to a DPT charge on an amount equal to premium net of claims and any expenses related to services provided to the UK company (regardless whether the premiums are at arm's length)

— HMRC are also of the view that certain fact patterns may also support the conclusion that investments funded by the premiums would have been held by the UK company. This could give rise to additional profits considered to be diverted, for example under a RAP that includes investment income from the insurance fund.

— HMRC accept that there may be genuine non tax commercial reasons for a non-insurance group to use a captive, but consider there are likely to be very limited circumstances where the specific fact pattern would support the conclusion that DPT is not in point. For example, the reinsurance of a very high proportion of the risk out to a third party reinsurer may be an indicator that the intragroup insurer has not been set up primarily to achieve tax reductions.

Insufficient Economic Substance Condition – relationship between sections 110(4/5) and 110(6)

The IESC is a further condition that must be met in order for the arrangements to be within section 80/81 (or for the mismatch condition under section 86 to apply). The IESC is met, broadly, in either of the following two circumstances:

S110(4) and s110(5) – Transactions test

This circumstance is present if at the time the material provision was made:

— It is reasonable to assume that the transaction(s) were designed to secure a tax reduction; and

— It is not reasonable to assume that the non-tax benefit referable to the transaction would exceed the financial benefit of the reduction

S110(6) – Entity test

This circumstance is present if it is reasonable to assume that the involvement of the low-taxed company or other person was designed to secure a tax reduction, unless either:

— It is reasonable to assume that the non-tax financial benefits of the contribution from the activities of that person's staff would exceed the financial benefits of the tax reduction (s110(7)(a)); or

— The income attributable to the functions performed by the staff of that person in relation to the relevant transaction(s) exceeds the other income attributable to the relevant transaction(s) (s110(7)(b)).

The Guidance in relation to the application of these tests has been revised. HMRC now emphasize that the Transactions test and the Entity test need to be considered separately. Accordingly, the transactions test needs to be considered even where the entity test is not passed because the income attributable to staff functions is more than the remaining income on the transactions.

The implication of this change of emphasis appears to be that, in most cases, HMRC would expect that a fact pattern such that the test in s110(7)(b) is met would, prima facie, suggest that it was not a reasonable assumption that the transaction(s) were designed to secure the tax reduction. However, it does leave open the possibility that this may not always be the case, and therefore it will be necessary to work through the Transactions test, even where the conditions in s110(7)(b) are met.

Section 86 – Lack of regulatory approval as a business reason

The Guidance notes that a foreign company may appoint a UK service provider whose activities are restricted because of regulatory constraints, such as regulatory authority to carry out transactions. The Guidance expresses the view that where a company is unable to obtain regulatory authority to perform certain activities, and this leads to limitations on what the service provider can do, this should normally be regarded as pointing away from those limitations being "designed" to ensure the foreign company has no UK taxable presence (DPT 1141). By implication, where the service provider could obtain regulatory approval for such activity, the mere fact it does not hold the necessary authorisation may not be enough to keep the arrangement outside section 86.

Illustration 5 – Section 86 Avoided Permanent Establishment

- A multinational manufacturing group has a European Sales Company ("ESC") in a low tax jurisdiction.
- ESC sells directly to third parties, and sales support is given by local distribution companies on the ground in each territory where sales are made (including the UK).
- From an examination of the facts and circumstances, it is established that there is a contrived separation of the conclusion of contracts from the selling activity and the process of agreeing terms and conditions. It is also established as a fact that ESC personnel add negligible value in signing contracts whose existence and terms are very largely attributable to activities carried on in the UK.
- The evidence also shows that all the work in negotiating UK sale contracts is done in the UK by the UK sales support company. The person in ESC who signs the contract merely checks the terms and makes sure the contract complies with the general standard form before signing it.
- In this case, it is reasonable to assume that the arrangement has been designed to keep ESC out of the charge to UK corporation tax. Accordingly, DPT will apply to the profits that would have been subject to UK corporation tax had ESC actually had a permanent establishment in the UK.

Administrative matters

There is no statutory clearance procedure for DPT. The new Guidance indicates that, although it may be possible for HMRC to provide a view on whether transactions are likely to fall within the scope of DPT, the required expenditure of HMRC resources will only be justified where there are special reasons for expending those resources (DPT 1600).

HMRC will carry out an initial risk review of businesses it considers may fall within the scope of DPT. HMRC will not usually request information at this stage. However, where it is not possible to determine whether the arrangements carry a high or low risk of being within the scope of DPT, HMRC will ask the business for additional information and analysis (DPT 1600).

Risk reviews will also consider challenges other than application of DPT, especially for periods before DPT applied, for example by reference to whether the transfer pricing is robust and whether there are any undeclared permanent establishments (DPT 2740).

What does this mean for corporate taxpayers?

The updated Guidance contains some welcome clarifications and additional examples - in particular the clarification that HMRC consider the DPT will only apply where there is 'contrivance' such that the arrangements differ in some material way from those which would have been made but for the opportunity to achieve a tax saving. However, taxpayers and HMRC may have differing views on whether an arrangement is contrived. Additionally, there are some areas, such as the interaction of the Transactions test and the Entity test in the IESC, where the Guidance has become less clear-cut.

Many common arrangements in multi-national groups, (e.g. captive insurance companies) will continue to require detailed analysis - both in order to assess the risk of an actual DPT liability and to assess the notification requirements.

Even where it is concluded that notification is not required, companies will still need to be prepared for questions from HMRC on DPT and what work they have done to analyse relevant arrangements - particularly where the group is categorized as 'high risk'. It is also likely that an analysis of DPT risks will also be needed for tax provisioning and audit purposes.

Where there are DPT risks, companies may also consider restructuring to instead bring those 'diverted profits' within the scope of UK corporation tax, which is one of the stated policy intentions of the DPT legislation.

Many companies are already approaching the notification deadline, and many others have to take a position on DPT for the purposes of the tax provision in the financial statements. Therefore, DPT is likely to be a key area of focus for tax departments.

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