CLIFFORD CHANCE

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# The new UK diverted profits tax: will it impact your business, and will it survive legal challenge?

For 120 years, foreign companies selling to customers in the UK have not been subject to UK tax on their profits unless they trade in the UK through a "permanent establishment". That is to change. The Government has published draft legislation enacting a "diverted profits tax" of considerable breadth, which will potentially apply to many foreign companies doing business in the UK, and many UK companies transacting with affiliates abroad.

We look at the scope of the proposed tax, how and when it will apply, and ask whether it is compatible with EU law and the UK's double tax treaties.

## Executive summary

This is an extra-territorial tax of unprecedented novelty and breadth.

As a high level summary, we believe businesses will need to consider whether the diverted profits tax (DPT) applies in all scenarios involving:

- a foreign company doing business with UK customers or counterparties which has a presence in the UK (itself, or through affiliates or third parties) but which does not currently give rise to a permanent establishment (save where an express exemption applies); or
- a UK company having arrangements with foreign affiliates which have the effect of reducing the UK company's taxable profits.

Only in some of these cases will DPT liability arise, but complex businesses may have to undertake significant work to determine that. They may, furthermore, have to notify HMRC even if they conclude no liability arises.

The DPT is a highly complex tax – as will be appreciated from the fact that this high level summary comes to eight pages.

The following paragraphs set out the background to the DPT, how the tax works, and who it is likely to affect. We then consider potential challenges to the tax, under double taxation treaties and EU law.

In our view, the DPT risks creating an administration and compliance burden out of all proportion to the projected yield. It is to be hoped the Government reins the tax back before the Finance Bill is published in April.

## Why a new tax?

The last few years have seen increasing Press and political focus on perceived avoidance by multinational companies. There has, in particular, been criticism of the use by US technology companies of the so-called "double Irish" structure to extract profits from their European

businesses without paying tax in either Europe or the US.

At the Conservative Party Conference, the Chancellor announced that a new tax would be introduced to counter the "double Irish" structure. In the Autumn Statement the tax was given a name – the "diverted profits tax", and we were told it would be targeted at multinationals who use artificial arrangements to divert profits overseas in order to avoid UK tax. The rate of the tax would be 25% and it would apply from 1 April 2015.

With the publication of the draft Finance Bill legislation on 10 December we can finally see how the proposed new tax works.

The surprise is that this is not a narrow rule aimed at technology companies, or the "double Irish" structure. Instead, the DPT represents a radical departure from the principle that the UK will not tax the profits of foreign companies doing business with UK clients/customers, unless those companies have a UK "permanent establishment".

The UK and other OECD countries have kept to that principle for over a century. Many thought that the OECD's BEPS project would lead to a gradual move away from that principle – it was not expected the UK would do so unilaterally.

We believe the DPT will apply in a wide variety of circumstances. That, together with the complexity and novelty of the tax, makes it hard to understate its potential effect on persons doing business with the UK.

## Key issues

- Entirely new tax to be imposed on cross-border businesses and transactions
- All foreign companies selling goods/services to the UK are potentially in scope
- All UK companies making tax-deductible payments to foreign affiliates are potentially in scope
- Companies required to notify HMRC if specified conditions are met.
- In practice, likely to override existing double taxation treaties
- May be contrary to EU law, and challenges are to be expected

## Two DPT flavours

The DPT applies in two distinct cases:

- where a foreign company structures its affairs to avoid a UK taxable presence; or
- where a company which is taxable in the UK creates a tax advantage by involving entities or transactions with a "lack of economic substance".

## Avoiding a taxable presence

This case will apply where the following conditions are met:

- there is a non-UK resident company (the "foreign Company");
- a person (referred to as "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;
- it is reasonable to assume that the activity of the avoided PE is designed to ensure that the foreign company is not treated as carrying on a trade in the United Kingdom through a permanent establishment by reason of the avoided PE's activity;
- it is reasonable to assume that either the "mismatch condition" or the "tax avoidance condition" are met.

The mismatch condition is met if:

- in relation to the supplies of goods or services arrangements are in place as a result of which provision (the "material provision") is made or imposed between the foreign company and another person ("A") by

means of a transaction or series of transactions;

- the relationship between the foreign company and A is such that the participation condition is met (i.e., broadly speaking, the parties are related);
- there is an "effective tax mismatch outcome" resulting from the material provision as between the foreign company and A (see below); and
- the insufficient economic substance condition is met (again, see below).

The mismatch condition will not be met where the companies concerned are both small or medium sized enterprises or the material provision is an excluded loan relationship (i.e., broadly speaking, a loan or debt instrument).

The **tax avoidance condition** will be met where there are arrangements in place in connection with the supply of goods or services, the main purpose or one of the main purposes of which is to avoid a charge to corporation tax.

# Entities or transactions lacking economic substance

This case applies in relation to a company (C) if:

- C is UK resident or a non-resident carrying on a trade through a UK permanent establishment;
- there is a provision (the "material provision") made or imposed between C and another person (P) by means of a transaction or series of transactions;
- C and P are connected such that the participation condition is met; and
- the material provision causes an "effective tax mismatch outcome" between C and P.

It seems to us most likely P will be a non-UK person, but the legislation expressly applies in the case where P is a UK person.

As with the permanent establishment provision there is an exception where both C and P are small or medium sized enterprises or where the material provision is an excluded loan relationship.

# Key concepts

### Effective tax mismatch outcome

There will be an "effective tax mismatch outcome" where the material provision results in an increase in expenses/deductions or a reduction in income for one party and the reduction in that party's tax liability is greater than any resulting increase in the other party's total liability to corporation tax, income tax or any non-UK tax.

This is subject to an "80% test" which provides that there will not be a tax mismatch outcome where the amount of tax paid by the second party is at least 80% of the corresponding reduction in the first party's tax liability.

So, for example, a royalty paid by a UK company to an affiliate in a tax haven will result in an "effective tax mismatch outcome" because the UK company will likely obtain a tax deduction for the royalty payment, but the affiliate will not be taxed on its receipt.

It's not relevant whether the deduction actually saves tax for the first party. If, for example, the UK company is loss making even before the royalty deduction there will still be an effective tax mismatch outcome (but the calculation provisions we discuss below will result in no actual liability).

### Insufficient Economic Substance Condition

This condition will be satisfied if either of the following apply:

- First, the financial benefit for both parties of the tax reduction is greater than any other financial benefit referable to the transaction or transactions, and it's reasonable to assume the arrangements were designed to secure the tax reduction. So even very significant non-tax financial benefits won't prevent the DPT applying if the tax benefits are more

significant. And any non-financial benefits (e.g. lifestyle choices of key personnel) are ignored when making this determination.

- Second, where the DPT applies to a company because it has entered into a "material provision" with an affiliated person, the contribution of economic value to the transaction by that person, in terms of the functions or activities of its staff, is less than the financial benefit of the tax reduction, and it's reasonable to assume the person's involvement in the transaction was designed to secure the tax reduction. SPVs will almost always fail the "economic value" part of this test.

# How DPT is calculated

The rate of DPT is 25%, which is applied to the company's "taxable diverted profits".

### Avoidance of a UK Taxable Presence

The basic rule is that the "taxable diverted profits" arising to the foreign company are an amount equal to the profits which it is just and reasonable to assume would have been the chargeable profits of the foreign company, attributable to the avoided PE, had the avoided PE been a permanent establishment in the United Kingdom through which the foreign company carried on a trade.

In circumstances where the mismatch condition is met and it is reasonable to assume that the material provision would not have been made or imposed in the absence of the effective tax mismatch outcome different rules apply. In this situation, it is assumed that a different (the "alternative provision") would have been made and this provision may be substituted to calculate the chargeable profits of the avoided PE. The alternative provision is that which it is just and reasonable to assume would have been made or imposed if the avoided PE had been a UK permanent establishment through which the foreign company carried on the trade and which would not itself have resulted in an effective tax mismatch outcome.

This limb of the charge will not apply where the sales revenue of the company and connected companies from all supplies of goods and services to customers in the UK are not more than £10 million in a 12 month accounting period.

It will be appreciated that both these rules require the construction of a counter-factual scenario, and then apply the tax on the basis of that scenario. What the correct counter-factual scenario should be in cases of complex cross-border businesses is likely to be hotly contested between HMRC and taxpayers.

### Entities or Transactions Lacking Economic Substance

The calculation of the DPT in this case again requires the construction of a counter-factual scenario.

In this case, the basic rule is that, where it is reasonable to assume that the material provision would not have been made or imposed in the absence of the effective tax mismatch outcome, the taxable diverted profits are the amount would have been the chargeable profits of C had it instead entered into such different provision as it is just and reasonable to assume would have been put in place and which would not have had an effective tax mismatch outcome.

If that alternative provision would result in another company having increased UK taxable income then C's diverted profits are increased by the amount of that income.

So in the simple case of arm's length royalties being paid by C to a tax haven affiliate, if the alternative provision is that the royalties would have been paid to a US affiliate (which would have been fully taxed on them) then it seems C will have no DPT charge. But if the alternative provision is that the royalties would have been paid to a UK company, or that no royalties would have been paid at all, then DPT will be charged at 25% of the amount of the royalties.

There is also an adjustment for transfer pricing (which essentially has the effect of accelerating a transfer pricing adjustment that ordinarily would require HMRC to open an enquiry against the company's corporation tax return in the usual way).

# Procedure

Most UK taxes are self-assessed. The DPT is quite different.

### Notification requirement on companies

A company must notify HMRC if it is potentially within the scope of the DPT. Notification is within 3 months of the end of the relevant accounting period.

The notification requirements are intentionally harsher than the actual conditions for the tax to apply.

A company is required to notify HMRC there is a potential "avoidance of a UK taxable presence" DPT charge if

- the company is non-UK resident;
- it is carrying on activity in connection with supplies of goods or services made by the non-resident to customers in the UK; and
- that activity does not give rise to a permanent establishment (other than because an exemption applies).

The other elements of the DPT are not relevant.

It seems to us almost every foreign company (above SME size) doing business with the UK will satisfy this condition, as there will almost always be someone carrying on activity in the UK in connection with the supplies of goods or services made by the foreign company. All such companies now have to determine if it is "reasonable to assume" that they "might" have DPT liability. We would query if that is realistic or workable.

A company is required to notify HMRC there is a potential "involvement of entities or transactions lacking economic substance" DPT charge if that charge were to apply were it to:

- disregard the 80% payment test in the "effective tax mismatch outcome" condition; and
- and disregard the requirement in the "insufficient economic substance condition" that it be reasonable to assume the arrangement was designed to secure the tax reduction; and
- the financial benefit of the tax reduction is significant relative to any other financial benefit of the material provision ("significant" presumably being a fairly low threshold).

Again, a company in this position will have to determine if it is "reasonable to assume" that it "might" have DPT liability.

### How HMRC trigger the DPT

Where a designated HMRC officer determines a company has DPT liability, he or she will issue the company a "preliminary notice". This will explain why HMRC considers that the tax applies.

Following receipt of the notice, the company has 30 days to make representations. Curiously, the HMRC officer can only consider representations made on certain specified grounds – so, for example, if a taxpayer believes the DPT does not apply because the arrangement was not designed to avoid a permanent establishment, that will not prevent DPT being charged.

Having considered any such representations, HMRC must then either issue a charging notice or confirm that no charging notice will be issued. If a charging notice is issued then the DPT (plus interest) must be paid within 30 days. The taxpayer is free to appeal the DPT in the usual way, but this will not delay payment of the tax.

All charging notices are required to be reviewed by HMRC within the year, and at this point all representations previously made by the taxpayer are taken into account. Any overpaid tax is then refunded.

# When is the DPT intended to apply?

HMRC set out a number of examples, some of which are similar to cases which have been in the Press:

### Sales of goods

A foreign company acquires widgets from a third party and sells them in the UK. Its UK subsidiary provides sales support services, but is careful to never conclude contracts with customers. Under current law, that means the foreign is not subject to UK tax on its profits, and it is based in a low tax jurisdiction.

HMRC say that if this results from intentional structuring then the "tax avoidance" condition will be met and so the "avoiding a taxable presence" DPT charge will apply.

We would say there are a great many companies in this category. If you are a business selling goods or services cross-border then you likely are careful to comply with local laws around permanent establishment. That compliance would now seem to potentially subject you to the DPT.

### Online services

A foreign company (FCo) provides online services to UK customers. A UK affiliate provides marketing and support services but is careful to never conclude contracts with customers. FCo is in principle subject to tax on its profits, but shelters those profits with a large royalty payment to a tax haven affiliate.

HMRC say the mismatch condition could be met or, failing that, the tax avoidance condition. The "avoiding a taxable presence" DPT charge will again apply.

This scenario is similar to the "double Irish" structure it was expected the DPT would counter. This result is therefore not a surprise. Whether the whole framework of the DPT is necessary to kibosh such structures is another question.

### Leasing

A company in the UK needs to invest in new plant and machinery. An affiliate SPV in a tax haven purchases the equipment and leases it to the UK company. Large lease payments then erode the UK company's profit. The SPV has no other activity.

HMRC say the contribution by the SPV's staff is of little economic value when compared with the UK tax reduction. It is reasonable to assume that the SPV's involvement was designed to secure the tax reduction. The "involvement of entities or transactions lacking economic substance" DPT charge therefore applies.

It is clear why HMRC would object to such a structure; however the DPT is not the obvious vehicle to counter it. A withholding tax on payments to tax havens would achieve a similar result with considerably more simplicity and certainty.

### IP development

A UK company (UKCo) jointly develops IP with a 3rd party company in the UK. UKCo has the opportunity to buy out the 3rd party once the development was completed. Instead, a new connected company in a low tax jurisdiction (IPCo) is established. IPCo acquires the IP which is subsequently licensed to UKCo. UKCo makes royalty payments in respect of that IP. IPCo provides IP protection and management activities and takes the risk of ownership.

HMRC say it is reasonable to assume that the acquisition of the IP would have been made by UKCo and the inclusion of IPCo was to secure the tax reduction. Hence the "involvement of entities or transactions lacking economic substance" DPT charge applies.

HMRC also outline an alternative scenario in which IPCo actively develops the IP itself; in that case they say the DPT does not apply.

# In what other cases could the DPT apply?

It is unclear how far DPT is intended to extend and, in particular, whether it captures (intentionally or by mistake) widely used structures which facilitate investment into the UK.

For example, various questions and uncertainties arise in relation to fairly plain vanilla asset finance/leasing structures, real estate development structures, financing structures, captive insurance structures and securitisation structures

The intention seems to be that the DPT does not apply to financing structures, with an exclusion for arrangements effected by loan relationships. However the exclusion only applies if the transaction in question "only" gives rise to one or more loan relationships. Given the complexity of most cross-border financings, we would query if this exclusion will ever be available.

This raises the question of whether financing from third parties could result in a DPT charge. The "involvement of entities or transactions lacking economic substance" DPT charge will generally only apply to arrangements between related parties. However the legislation imports the transfer pricing concept of treating lenders as related parties in certain circumstances. How this will work in practice is entirely unclear.

There is also a fundamental question as to the scope of the "avoiding a taxable presence" charge. It applies where "supplies of goods or services" are made by a foreign company to UK customers. The terminology seems to have been borrowed from VAT legislation, but what does it mean in this context?

- Is the grant of a loan to a UK person a "supply of services"?
- What about the acquisition of a pre-existing loan?
- Does the concept include sales of real estate?
- And, if so, only sales to UK persons, or all sales of UK real estate?

# When won't the DPT apply?

There are some cases where it seems clear the DPT won't apply.

- It is common for UK investment managers and brokers to enter into transactions on behalf of non-resident financial institutions, funds, SPVs and others. There are specific statutory exemptions which (provided certain conditions are met) prevent this giving rise to a permanent establishment. Where these exemptions apply, the DPT is expressly disapplied.
- The "avoidance of a UK taxable presence" charge won't apply to a company that already has a UK permanent establishment as a result of the activity carried on in the UK. This will be the case even if the arrangement has been structured so the taxable profits are very limited (although if payments are being made to affiliates then the "involvement of entities or transactions lacking economic substance" DPT charge may apply instead).
- The "involvement of entities or transactions lacking economic substance" DPT charge will not apply where a provision results in a tax mismatch, but the provision is made between unrelated parties (save where the special financing rule mentioned above applies).

# How much will the DPT raise?

We see the DPT as a radical new tax that will apply in a great many cases, and/or prompt businesses to rearrange their affairs and as a result pay significantly more corporation tax.

Surprisingly, the Chancellor seems to disagree – the forecasted annual revenue is only around £300m. This suggests either that the Chancellor is being extremely cautious, or that the breadth of the tax is unintentional.

# Unintended consequences

### Will other countries retaliate?

It is possible that the Government discussed the DPT with other OECD governments, and even that there is agreement that others will take similar steps (through the BEPS Project or

otherwise). Australia has already suggested it will follow suit.

But this is not part of a coordinated action then other governments may take a dim view of the UK taking such dramatic unilateral action. We could see retaliatory measures introduced, particularly in the US.

The existing consensus around taxation of non-residents has been supported by successive Governments in the belief that it benefitted inward investment; and in particular that if everyone were to tax non-residents more aggressively then the UK economy, and the UK taxman, would lose more than they would gain. We would hope the Treasury has considered the impact on UK exporters of similar taxes being imposed on them by the jurisdictions in which they operate, and the knock-on effect on corporation tax receipts.

### Will some businesses leave the UK?

Amongst all the uncertainty, one thing is clear – the easy way to escape the DPT is to simply have no UK presence at all.

For some this will not be possible – for others it will be, particularly those providing electronic rather than physical goods and services. Such a company could continue to provide goods and services to UK customers, pay no UK tax, and be entirely outside the DPT.

If the DPT remains as currently drafted, and HMRC enforce the tax aggressively, then we may see a number of multinationals reducing or even eliminating their UK presence. This is presumably not the result the Treasury intends.

## Does the DPT breach the UK's double tax treaties?

In taxing foreign companies that do not have a UK permanent establishment, the DPT will apply in cases where the UK's double tax treaties with other jurisdictions prohibit the UK from taxing their residents.

Apparently the HMRC view is that the DPT is not "corporation tax" and so not covered by the UK's double tax treaties. We would disagree. Many of the UK's double tax treaties – for example those with France, Germany, Jersey, Luxembourg, The Netherlands, Singapore and the US – apply to corporation tax, income tax and other similar taxes. It seems to us clear that, in taxing corporate profits, the DPT is similar to corporation tax and so does fall within these treaties. It is also arguable – albeit less clear – that even a treaty that only applies to "corporation tax" should be read to apply to DPT as well given the nature of the tax.

There are then two possible outcomes.

First, these treaties could override the DPT. This seems to us the most likely result as the draft legislation stands. The effect would be that the DPT does not apply to companies based in one of the jurisdictions listed above. We cannot imagine HMRC would accept such an outcome.

Alternatively, the DPT could override the treaties. We expect HMRC will in due course amend the draft legislation to make clear that is the intended result. In principle this would be a breach of international law, but the only party with standing to litigate the breach would be the other State. Taxpayers would have no recourse. This has been the result when the US, Germany and other countries have developed domestic laws that expressly override treaties, and we expect it would be the result here too.

## Does the DPT breach EU law?

This is a more difficult question.

In the *Cadbury Schweppes* case, the Court of Justice of the European Union (CJEU) considered the legality of the UK's "controlled foreign company" rules, which (very broadly) imposed UK tax on the profits of foreign subsidiaries of UK companies if those subsidiaries paid less tax than they would have done were they established in the UK.

The CJEU held that the CFC rules were an unlawful infringement on the EU freedom of establishment

unless they only applied to "wholly artificial" arrangements. The UK responded by rewriting its CFC rules (although whether the new rules have fixed the problem is in our view very much open to doubt).

When imposed on EU companies, the DPT would seem to raise similar issues to the CFC rules. In taxing EU companies that do business with the UK, the DPT potentially infringes their freedom of establishment and/or the freedom of movement of goods and services. This would not be problematic if the DPT were limited to "wholly artificial arrangements", but it will be seen from the summary of the DPT above that even arrangements with a very significant non-tax purpose can be subject to the DPT.

The fact the 25% rate of DPT is higher than the 20% rate of corporation tax also raises the question of whether the DPT is discriminatory, i.e. because foreign companies doing business in the UK will potentially be subject to tax at a higher rate than UK companies carrying out the same activity.

We would therefore see EU law challenges as inevitable if the DPT is adopted in its present form, and – whilst the CJEU's caselaw in this area is rapidly developing - there is a real possibility that the UK would lose such challenges.

As an aside, the curious limitations on the grounds for a taxpayer to contest an HMRC preliminary notice may also be contrary to EU law (and potentially also the Human Rights Act).

# Further information

If you would like further details on any aspect of the DPT, or how it applies to your institution or transactions, please speak to your usual Clifford Chance contact or any of those listed overleaf.

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