UK's 'Diverted Profits Tax' proposes a 25% tax rate for taxpayers but leaves open questions

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In brief

On December 10, 2014 HM Revenue & Customs (HMRC) released the diverted profits tax (DPT) provisions within its draft Finance Bill 2015. Upon initial review, the new rules could affect many more companies than one might have anticipated.

The DPT is a new tax, with a 25% rate on profits that are considered to be artificially diverted from the United Kingdom. The legislation will apply to profits arising after April 1, 2015. Furthermore, if taxpayers potentially are within the scope of the tax, they must notify HMRC within three months of the end of the relevant accounting period. As this tax is not considered to be a corporation or income tax, it creates uncertainty about the availability of tax relief under existing double tax treaties. However, when computing taxable profits taxpayers may deduct any corporation tax paid on the 'diverted' profits. Multinational corporations should consider whether the DPT will be a creditable tax.

The legislation is very complex. There are two sets of conditions under which DPT would apply. Often both will apply to the same fact pattern.

In summary, the DPT might apply to:

1. a company that has UK sales made by a related non-UK company or Permanent Establishment (PE), and/or

2. a UK company/PE that has a significant transaction with a related company.

In either case, for DPT to apply, any related income must end up in a related company that has a low tax rate or receives concessionary tax treatment.

In detail

A simplified summary of the two tests is outlined below:

Avoidance of UK PE

The first test is called 'avoidance of a UK PE'. It applies where a foreign company sells goods or services to UK customers, and a related UK party performs sales-related activities. An example is marketing support services.

For the DPT to apply there needs to be a main purpose to avoid tax. Alternatively, a taxpayer would need to meet the "tax mismatch" conditions. Under the tax mismatch conditions, foreign company profits are taxed at a rate lower than 80% of the UK corporation tax rate and the foreign company does not meet the economic substance test (more on this below).

In order to calculate the profits to which DPT would apply, taxpayers must attribute profit to a deemed PE. This analysis is complicated as there are interactions between this calculation and the 'insufficient economic substance' test (below). Therefore, if the foreign company is engaged in other transactions which do not meet the economic substance test (e.g., the license of intangible property from a related company), then those transactions entered into by the foreign company may be ignored when calculating the deemed PE profits.

Insufficient economic substance

The second test is the 'insufficient economic substance test'. Taxpayers meet this test if it is reasonable to assume that one or more transactions were designed to secure a tax reduction. Tax is defined to include non-UK tax as well as UK tax.

If taxpayers meet this condition, the DPT applies where a UK company or PE makes payments to another company or there is a reduction in UK income, and either:

- the tax reduction resulting from the transaction(s) exceeds any of the transactions' other financial benefits, or
- where the contribution of economic value to the transactions(s) by the other company is less than the tax reduction. The contribution of economic value focuses only on functions and activities performed by the company (or outsourced to third parties). It appears to ignore any contributions to the company's profits generated through the capital and assets owned or risks borne.

In order to calculate the profits to which DPT would apply, taxpayers must determine the difference between the actual profits and a deemed profit amount, i.e., profits calculated without the tax mismatch. This test may be very subjective.

The takeaway

From a policy perspective, this legislation precedes the developing Base Erosion and Profit Shifting (BEPS) agenda.

The DPT tests are difficult to apply and its elements are subjective. The insufficient economic substance test is concerning because it narrowly focuses on activities and functions. Thus, in practice taxpayers may find it difficult to assess their position and be confident that they have passed or failed the test.

US multinational companies should consider these changes as a matter of urgency. The April 1, 2015 effective date and tight notification and payment schedule limit the time for what might be a complex review and analysis.

Finally, HMRC has invited comments on this draft legislation. Taxpayers should consider engaging in the consultation process.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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