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A practical approach to the DPT

Much has been written about the rights and wrongs of the Diverted Profits Tax included in Part 3 of the Finance Act 2015. This article faces up to the reality that it is now on the statute books and so has to be considered alongside other taxes in the course of providing UK tax advice.

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One of the few things that might be said in favour of the Diverted Profits Tax (DPT) is that it is admirably concise. However, that doesn't mean it is easy to approach and this article is heavily reliant on HMRC's interim guidance. Reliance on guidance is likely to remain a feature of applying the legislation in practice, which is highly unsatisfactory both from the point of view of certainty and also in the amount of discretion that is effectively handed to HMRC.

While there are some shared mechanics, the DPT can apply a charge to tax in essentially two different circumstances: the first is effectively an expansion of transfer pricing; and the second is effectively an expansion of existing rules allowing the UK to tax non-resident companies trading in the UK through a UK permanent establishment (PE). This article describes the former as a 'Section 80 case' and the latter as an 'Avoided PE case'.

An early word of caution relates to the origins of the DPT. The application of the DPT is much broader than simply to the tax planning arrangements of large multinational corporations. In particular, asset managers and real estate investors and developers will need to grapple with the DPT legislation.

The Section 80 case

Most people reading this are likely to have a mental checklist of tax issues to run through when they first see a new transaction. On our list, the Section 80 case now sits alongside transfer pricing on the basis that, while slightly adjusted, the basic circumstances in which the two can apply are the same.

Application of DPT under the Section 80 case is subject to a participation condition being met by the persons between whom a 'material provision' giving rise to an 'effective tax mismatch outcome' is made or imposed (C and P).

In most cases, P will be a non-UK person, but the legislation expressly applies in the case where P is a UK person. It is worth noting at the outset that there is an exception from the Section 80 case where both C and P are small or medium-sized enterprises (SMEs).

For the purpose of DPT, the participation condition is worded in a similar way to the participation condition in the transfer pricing rules. It requires one of the persons to be directly or indirectly participating in the management, control or capital of the other, or the same person to be so participating in each.

There are separate conditions relating to financing arrangements and provisions which are not financing arrangements. For these purposes financing arrangements are defined widely, being those made for providing or guaranteeing or otherwise in connection with any debt, capital or other form of finance. The condition in relation to financing arrangements considers the position at the time the material provision was made or imposed, and for a six-month period from that time, whereas the condition in relation to non-financing arrangements looks only to the time that the material provision was made or imposed.

However, rather than requiring a 'non-arm's length provision' and a 'potential advantage in relation to UK taxation', a Section 80 case requires an 'effective tax mismatch outcome' and for the arrangements to have 'insufficient economic substance'.

An 'effective tax mismatch outcome' arises 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 similar non-UK tax.

This is subject to an '80% test' which provides that there will not be an 'effective 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. Unlike transfer pricing, non-arm's length arrangements between persons subject to similar tax rates, for example between two companies within the normal charge to UK corporation tax, will not be caught.

Transfer pricing interaction

Clearly there is considerable overlap with transfer pricing, and HMRC's guidance is quite explicit that one effect of the legislation is to give them a bigger stick where there is a 'transfer pricing impasse'. If the taxpayer fails to move to

a position which is satisfactory to HMRC, HMRC will issue notices triggering the higher charges (due to the rate) and early payment required under the DPT.

While arm's length arrangements (or non-arm's length arrangements with an acceptable transfer pricing adjustment) are within the scope of the Section 80 case, in most cases they will result in a calculation of zero taxable diverted profits under section 83 FA 2015.

However, this will not always be the case. The charge is calculated by reference to the 'relevant alternative provision' being the alternative provision that it is just and reasonable to assume would have been made or imposed, rather than the material provision, as between the relevant company and any connected company had tax on income not been a relevant consideration for any person at any time. While transfer pricing is nearly always a case of adjusting the pricing of a particular transaction, the Section 80 case anticipates the possibility that no transaction, or a different transaction, may have taken place and considers the UK tax consequences in the current period of that virtual world.

HMRC suggest that a 'relevant alternative provision' is likely to apply in circumstances such as: (i) where an overseas group company resident in a low tax jurisdiction is used to acquire plant and machinery that a UK operating company uses to carry on its trade through an operating lease (and which, absent tax considerations, would have been acquired directly by the UK entity); or (ii) where the IP for a group (which would otherwise have been held by a UK group company) is held by an overseas group company resident in a low tax jurisdiction and a UK operating company licenses that IP from the overseas group company for a significant fee.

Limits to Section 80 Case

Once the Section 80 case alarm bell has started ringing, is there any escape?

Notably DPT will not bring into charge any profits relating to transactions involving only loan relationships, or from a loan relationship and a derivative contract entered into entirely as a hedge of risk in connection with the loan relationship. The existence of a loan relationship, or loan relationships, within the material provision that gives rise to an effective tax mismatch outcome does not, of course, automatically mean that the outcome is excepted. It must arise wholly from the loan relationships and/or hedging contract. In practice this is likely to remove most tax optimised financing arrangements from the scope of DPT. The rationale for this approach is that the UK is already consulting on separate rules for hybrid mismatch financings (at least here the UK appears content to await the outcome of the Organisation for Economic Co-operation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) project).

As stated above, in order for the Section 80 case to apply, the insufficient economic substance condition also needs to be satisfied. This condition will be satisfied if either a transaction based condition or an entity based condition is satisfied.

The transaction based condition will apply where the effective tax mismatch is referable to a particular transaction or transactions, and it is reasonable to assume that the transaction (or transactions) was designed to secure the tax reduction, unless it was reasonable to assume at the outset that judged over the life of the arrangements the non-tax benefits of the transaction would exceed the financial benefit of the transaction. For example, if a group has a supply chain that is inefficient from a logistics perspective, if the reorganisation of that supply chain brings about an overall reduction in tax, the condition would not be satisfied unless the tax saving outweighs the logistics saving.

The entity based condition applies to any person who is party to the transaction where it is reasonable to assume that that person's involvement is designed to secure the tax reduction unless either:

- at the time of making the material provision, it was reasonable to assume that the non-tax benefits attributable to the person's staff would exceed the overall financial benefit of the tax reduction relating to the transaction; or
- the income attributable to the contribution of the person's staff (ignoring activities relating to holding, maintaining or protecting any asset from which the relevant income derives) to the transaction in an accounting period exceeds other income attributable to the transaction (it is not clear, but we would not ordinarily expect the value of the tax reduction to be included in income).

This entity based condition is likely to be more difficult to escape. HMRC give the example of an IP company which continues to develop the IP it holds by undertaking its own R&D activities. It is clear from HMRC's examples that they take the view that the entity based condition can apply to more than one party to the same arrangement. The emphasis on staff means that factors such as the entity's access to capital or ability to bear risk are unlikely to be relevant. It will be important for entities relying on this condition to ensure that their reasons for doing so and any forecasts they are relying on are well documented.

As an aside, it is also worth noting that, although there is no Targeted Anti-Avoidance Rule (TAAR) in the DPT legislation, the HMRC guidance explicitly states that it will seek to apply anti-avoidance provisions, including the General Anti-Abuse Rule (GAAR), to 'contrived attempts' to circumvent the DPT.

Notification

A company must notify HMRC if it is potentially within the scope of DPT. For the purposes of the notification requirement only, the 'insufficient economic substance condition' is ignored. However, where there is a 'tax mismatch outcome', there is an additional requirement

that the financial benefit of the tax reduction must be 'significant' relative to the other benefits of the transaction. The recently revised HMRC guidance does not explore the meaning of a 'significant' financial benefit.

In addition, under section 92(7) FA 2015, there is no requirement to notify if:

- the company has notified (or has not notified on the basis of the following bullet) for the preceding accounting period, provided that there has been no change in circumstance material to whether a charge to DPT arises;
- it is reasonable for the company (or a connected company) to conclude that it has supplied information which is sufficient for HMRC to decide whether to give a preliminary notice for that period and that HMRC has examined that information (whether as part of an enquiry into a return, or otherwise); or
- it is reasonable for the company to assume that a charge will not arise. However, if the only reason the company assumes this is on the basis of the possibility of future transfer pricing adjustments (which may reduce or eliminate the DPT charge), then the company will have to notify.

It must be noted that these exemptions apply only for the purposes of determining whether or not a company potentially within the scope of DPT must notify HMRC. They do not mean that a liability to DPT cannot or will not arise. A company that is not required to notify on the basis of the exemptions, including cases where the company has received confirmation from an HMRC officer that no notification is required, may still have a liability to DPT and be subject to the charging, penalty and other provisions.

The Avoided PE case

The alarm for this case is broadly the same as for trading in the UK through a PE. In summary, the scope of the domestic charge is slightly expanded and treaty protection is removed, in either case where a tax avoidance motive exists.

The charge to corporation tax for non-residents

It is worth describing briefly how the charge to UK tax for non-resident companies works. Under section 5(2) of the Corporation Tax Act 2009, a non-resident company is within the charge to corporation tax only if it carries on a trade in the UK through a PE in the UK. There are three conditions here: first 'a trade', second 'in the UK' and third 'through a PE'. It should also be noted that if a non-resident company meets the first two conditions but not the third, it can still be liable to income tax unless a double tax treaty applies (although there is no clear mechanism for HMRC to collect this tax). Of course, if a double tax treaty applies, that will limit the charge to corporation tax too.

Whether a particular transaction or activity amounts to a trade for UK tax purposes is a question of fact, though there is a considerable amount of case law and guidance to assist with this difficult determination.

Whether a trade is carried on in the UK is also a question of fact and the subject of considerable case law. The place of conclusion of contracts is a key factor.

For UK domestic purposes, a company has a PE if it has a fixed place of business through which the business of the company is carried on, or an agent acting on behalf of the company has and habitually exercises authority to do business on behalf of the company. An agent of independent status acting in the ordinary course of the agent's business will not give rise to a PE. Where specific criteria are met, brokers, investment managers and Lloyd's agents are deemed to be agents of independent status.

In practice the situations in which a company is carrying on a trade in the UK but escapes the corporation tax charge because it does not have a PE are likely to be limited (see the decision of the Special Commissioners in *IRC v Brackett* [1986] STC 521), except where the reason for its not having a PE is that there is an agent of independent status.

Non-resident companies will commonly argue either (i) that they are not trading, (ii) that contracts are not concluded in the UK, (iii) that they are acting through an independent agent, or (iv) that the charge does not apply as a result of one of the UK's double tax treaties, which, generally speaking, do not entitle the UK to tax business profits of a non-resident company unless they are attributable to a UK PE as defined for the purposes of the treaty.

Avoided PE case conditions

The basic requirement for the Avoided PE case is that a person is carrying on activity in the UK in connection with supplies of services, goods or other property made by a foreign company in the course of a trade. It is further necessary that it is reasonable to assume that any of the activity of either the avoided PE or the foreign company is designed so as to ensure that the foreign company does not, as a result of the avoided PE's activity, carry on that trade in the UK for the purposes of corporation tax (the design condition).

In other words, if you are organising your arrangements so as to stop short of having a taxable UK PE, you are within the scope of DPT.

It is interesting that the design condition does not actually look at the question of whether there is a UK PE at all. Instead it looks at whether the arrangement is designed so that foreign company is not carrying on its trade in the UK. While it looks a little strange, given the focus on 'avoided PEs' elsewhere, it seems to us that this is technically the correct question. As a result, the design condition should not be satisfied where arrangements have been carefully structured so as to avoid a trade

which is carried on in the UK being carried on through a PE – for example, due to the investment manager's exemption (the IME).

Following revisions made to the draft legislation, it is now clear that trades of all types are likely to be caught (under the initial draft there was a question mark over property development and trading), and that the location of the customers is irrelevant (an earlier draft limited the legislation to UK customers). The tax is the primary liability of the foreign company, but can also be collected from the avoided PE.

There is a tax avoidance motive condition. However, HMRC have indicated that they plan to interpret this strictly:

> *"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."*

In the absence of a tax avoidance motive, the legislation can still apply if the mismatch and insufficient economic substance conditions apply (broadly the same as the equivalent conditions for the Section 80 Case, above). It is, however, difficult to envisage a situation where this would be the case.

Which of these conditions applies (the tax avoidance condition or the combination of the mismatch and insufficient economic substance conditions) needs to be determined if a charge needs to be calculated under the legislation, as this works differently where the mismatch condition applies (in effect this will be the case where a company has both avoided a PE and as part of the same arrangement entered into an arrangement which, had it been a UK corporation taxpayer, would have been a Section 80 case).

Unlike the Section 80 case, there is no overlap with the normal charge to Corporation Tax where the foreign company does acknowledge a UK PE. The Avoided PE case does not work to stack the deck in favour of HMRC on any impasse as to the amount of profits that should be attributed to a UK PE.

Limits to the Avoided PE case

The most important limit is likely to be that, for unconnected parties, there is an exception where the avoided PE qualifies as an agent of independent status for UK domestic purposes.

Unfortunately, the drafting means that the scope of this limit is not clear. The more limited reading is that it only applies where the arrangement is such that the foreign company is actually trading in the UK through the avoided PE and that it is only not taxable because the avoided PE is an agent of independent status. The wider reading is that the exemption should apply where the arrangement has been structured so as to avoid trading in the UK, but had it not been structured that way, the agent of independent status exemption would have applied to the avoided PE in any case. Hopefully this will be clarified, as it is often the case in practice, to rely on a number of arguments (for example, that the company is not trading, or if it is, the arrangements are designed so that it is not trading in the UK, or, if it is, it is only doing so through an independent agent).

For connected parties this exception is narrowed so that it only applies where the avoided PE qualifies for the IME, independent broker, or Lloyd's agent exemptions. The question as to connection may be significant therefore in cases where the agent can be regarded as independent but does not or may not satisfy the detailed conditions of the IME. In this regard it should be noted that the connection test can throw up some surprising results, particularly where partnerships are involved.

As with the Section 80 case, the Avoided PE case will not apply where the avoided PE and the foreign company are both SMEs. In addition, the Avoided PE case will not apply if sales revenue made by the foreign company as a result of UK activity is less than £10m. The legislation also includes a further exclusion where UK-related expenses (i.e. those referable to UK activity) are below a *de minimis* amount of £1m.

It is notable that all of the examples of the Avoided PE case in the interim HMRC guidance involve connected parties whose function falls just short of concluding contracts. Arrangements between connected parties are already within the scope of transfer pricing. However, it is commonly assumed, including by tax authorities, that if the connected party were to be a PE, the profits that would be attributed to the foreign company as a result would be greater than the arm's length profit required for transfer pricing purposes. However, one of the examples given by HMRC demonstrates that this will not always be the case on application of the authorised OECD approach to attributing profits to PEs. Rather than having to rely on a nil charge in this situation, HMRC appear to take the view that if, on a close analysis, UK tax is not in fact avoided, then the arrangements cannot have had a main purpose of avoiding UK tax. This is helpful, if somewhat questionable, and it may be that practitioners need to become more familiar with these rules rather than assuming that PE status is bound to have an adverse tax impact. It should, however, be noted that OECD guidance clearly refutes the proposal that if a connected agent is being remunerated at arm's length there cannot be any additional taxable profit allocated to that company if it is also found to be a PE.

There are likely to be cases where the application or otherwise of the Avoided PE case boils down to the design condition. It may be argued that arrangements fall

short of trading in the UK, not by design, but because that reflects the nature of the commercial arrangements.

While there is no explicit substance condition in the Avoided PE case, HMRC guidance indicates that it is likely to be a significant factor in applying the design condition. HMRC examples show the analysis changing where there is substance in the foreign company, in particular a 'large staff of qualified people'.

Treaty override

HMRC take the view that as a new tax and as a tax on virtual rather than actual profits, the DPT overrides the UK's double tax treaties. Much has already been written about whether this view is correct and there is clearly some scope for argument here. However, simply relying on HMRC to be wrong on this point seems a dangerous approach.

A hitherto common approach to the UK corporation tax treatment of foreign companies is to ignore domestic legislation and rely on treaty protection. Some positions under the UK's treaties (and even the OECD model) do produce some surprising outcomes, and these lines look likely to be redrawn under the BEPS project (shortly before finalisation of this article the OECD published a new discussion draft on *Action 7: preventing the artificial avoidance of PE status*, which makes for an interesting comparison with the Avoided PE case). However, the UK has not waited for the outcome of this and it is now necessary to consider the position under UK domestic law first and if it turns out it is actually necessary to rely on a treaty, it will then be necessary to consider the design and motive tests. For example, preparatory or auxiliary activity is specifically excluded under most of the UK's treaties but not under domestic law.

Notification

Again, the conditions are modified for the purposes of determining whether notification is needed. Instead of the design condition, the modified condition is that the foreign company is not, as a result of the Avoided PE's activity, carrying on a trade in the UK for the purposes of corporation tax. Instead of the tax avoidance motive condition, there is a requirement that there exist arrangements which result in the reduction of a charge to corporation tax and as a result of which there is an overall reduction in the amount of tax (including foreign tax) payable in respect of the activities carried out in the UK by the Avoided PE.

The revised motive test is very difficult to apply. The references to a 'reduction' and the tax 'that would otherwise have been payable' make it clear that this is intended to be measured against a comparator. However, the ultimate question is whether tax (UK and non-UK) has been reduced in respect of the UK activity which is actually carried on, rather than the UK activity which would have been carried on had the arrangements not, for example, had the UK person stopping short of entering into contracts on behalf of the principal.

The exceptions in section 92(7) FA 2015 described above will also apply here, including the exception which applies where it is reasonable to conclude that no charge to DPT will arise.

Final word

The scope of the DPT charges is wide and clearly defined exemptions are limited. As with CFC rules and the debt cap, many businesses which are not the main target of the rules will need to spend time working out exactly how they escape. Some may be surprised to find they do not escape at all. The immediate challenge will be to consider whether existing arrangements need to be notified.

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