



## UK HMRC issues update on diverted profits tax

### Executive summary

In advance of final legislation being published in the Finance Bill on 24 March 2015, HM Revenue & Customs (HMRC) has responded to the representations that it has received on the draft clauses on diverted profits tax (DPT) released on 10 December 2014.

A key concern expressed was the breadth of the notification requirements. These have been narrowed from the original draft, focusing on situations where the financial benefit of the tax reduction is significant relative to the non-tax benefits of the material provision. Furthermore, there is an opportunity for groups to proactively discharge their DPT notification obligations by providing HMRC with, and ensuring HMRC has examined, sufficient information to able it to determine whether a DPT assessment notice should be issued. This will be welcomed by many taxpayers.

Despite the narrowing of the notification provisions, it is clear that HMRC continues to intend DPT to have a very wide scope. In fact, the scope of the avoided permanent establishments rule has been expanded to include sales to non-UK customers that relate to UK business activity and to sales of land and property. It has also been put beyond doubt that UK headed-groups that have suffered a UK controlled foreign corporation (CFC) charge, could still be subject to a DPT charge. Credit will, however, be available where a company has paid a CFC charge.

As expected, it has been confirmed that DPT will not apply where there has been a wholesale transfer to a lower tax jurisdiction of the economic activity needed to generate the associated income. Specific details of how this will be applied are yet to be received but the briefing note published on 20 March suggests that merely the holding, maintenance or legal protection of intellectual property will not be considered sufficient to avoid a DPT charge.

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Full legislation will be published as part of the Finance Bill on 24 March and HMRC's summary note makes the point that there may be minor changes between now and then. However, there will be little opportunity to debate the legislation further, given that the Finance Bill is expected to receive Royal Assent later this month.

This Alert summarizes the changes that HMRC is proposing to make and looks at how groups can best prepare for DPT coming into force on 1 April 2015.

### Detailed discussion

#### **Narrowing the notification requirement**

There will be no duty to notify for an accounting period if:

- ▶ HMRC has confirmed that there is no duty to notify;
- ▶ It is reasonable for the company to conclude that sufficient information has been supplied to enable 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 conclude that no charge to diverted profits tax will arise. However, if the only reason why it is reasonable for the company to conclude this is the possibility of future transfer pricing adjustments (which may reduce or eliminate the DPT charge), then it will still have to notify.

The draft legislation has been amended so that once the company has notified for one period, it does not have to notify for the next period provided that there has been no change in circumstances material to whether a charge to DPT arises. This will also apply where a company has not notified because it has previously supplied sufficient information and there has been no material change in circumstances.

Where the tax mismatch test is applicable, a group which passes it (i.e., tax has been paid on the relevant amount at 80% or more of the UK rate) will not be subject to the notification requirement. Finally, the intention is to amend the legislation to extend to six months after the end of the relevant accounting period the time allowed for initial notification when the tax comes into force. This means that a company with a 31 December 2015 year end will not have to notify until 30 June 2016.

This is a welcome relaxation of the notification rules that under the original draft would have required many companies to notify each accounting period even where it was clear that they would ultimately not be liable to DPT.

#### **Clarifying rules for giving credit for tax paid**

The right for a company to claim credit for overseas tax paid on profits in respect of which a DPT liability arises has been extended so that credit can also be given for foreign tax paid by another

company on those profits (e.g., where there is tax consolidation), as well as tax paid on those profits under both UK and overseas CFC regimes.

Although CFC charges can be credited against a DPT liability, they are not factored into the tests determining whether a DPT liability arises. This means that, for example, UK groups holding intellectual property in low tax jurisdictions with insufficient substance are within the scope of DPT even if they are subject to a CFC charge in respect of those profits. In such a scenario, the group will pay a UK CFC charge at 20% on the resulting profits and an extra 5% DPT on top of that.

Although the UK CFC rules are targeted at diversion of profits from the UK, there could be a number of circumstances where there would be no CFC charge and yet a liability to DPT would arise.

#### **Economic substance**

The arrangements to which the legislation is intended to apply are contrived ones that lack economic substance and are designed to reduce tax. Amendments to be made are intended to make it clear that the economic substance test is not failed where the majority of income earned by a company, in relation to a particular material provision, reflects ongoing work carried out by the company.

This means that DPT will not apply if a company decides to take advantage of lower tax rates offered by another territory by means of a

wholesale transfer of the economic activity needed to generate the associated income.

To prevent abuse this will not apply where the only activity carried out is work related to the holding, maintenance or legal protection of the asset that gives rise to the income.

Groups will be able to move to low tax jurisdictions and take advantage of special regimes as long as they have sufficient substance. While not defined in the HMRC announcement, this is likely to equate to the DEMPE functions outlined in the base erosion and profit shifting transfer pricing work on pricing intangibles, rather than the actual research and development which is relevant to the harmful tax practices work on nexus. There will be human capital implications to either ensuring there is enough substance offshore or bringing activities back to the UK to avert a DPT charge.

### **Avoidance of a UK taxable permanent establishment**

DPT addresses contrived arrangements which avoid a UK permanent establishment (PE) and in such cases applies a charge as if there were an actual UK PE.

New amendments are intended to operate such that, where it is established that contrived arrangements have been put in place to avoid a UK PE, HMRC will be able to attribute the profits that would have been attributed in a normal PE case. This will include profits relating not only from

sales to UK customers as in the current draft but also from sales to customers in other countries that relate to the UK business activity.

The avoided PE rules do not apply if the UK sales are less than £10 million (the sales threshold test). The original draft legislation aggregated connected party sales from UK activity when applying the £10m sales threshold test. This will be amended so that it is clear that, in calculating whether the threshold has been breached, connected party sales are ignored to the extent they are already taken into account in computing corporation tax profits.

Furthermore, the legislation has been amended to provide an exclusion where UK-related expenses (i.e., those referable to UK activity) are below a *de minimis* amount of £1m. This helps to address low risk situations where the UK sales threshold may be exceeded.

The exemption for groups with UK expenses below £1 million is welcome since it takes out of scope where executives visit the UK to oversee local subsidiaries that are fully within the charge to UK corporation tax.

Many have suggested that the DPT should not apply where the only UK activities are non-sales related activities for which the UK has been appropriately rewarded. However, there is no suggestion that this representation has been taken on board.

The legislation will also be amended to put beyond doubt that sales of land and buildings can also give rise to an avoided PE.

This amendment means that DPT can affect non resident property developers who are perceived to have avoided a PE to take UK gains out of tax.

### **The meaning of “excluded loan relationship”**

DPT will not now apply where the tax mismatch outcome is solely a result of differences in the way that debits and credits of a loan relationship are brought into account. This will also cover ordinary derivatives used solely to hedge these excluded loan relationships.

It had been hoped that all derivative contracts would be excluded from the tax mismatch test rather than just hedging transactions since this would have been a welcome simplification of the rules.

### **Other clarifications**

- ▶ The amendments set out how DPT applies in transactions involving charities and authorized investment funds.
- ▶ The amendments also set out how DPT applies to the oil and gas regime both in terms of the application of the mismatch test and the rate of DPT to be applied.

### **Implications**

No notification is required where a company has given HMRC, and HMRC has examined, sufficient information in order to determine whether a DPT assessment notice

should be issued. HMRC can either explicitly confirm that to be the case or alternatively a company can self-assess where it is reasonable for the company to reach such a conclusion. This exercise needs only to be completed once, unless there is a material change in circumstances.

Based on our recent experience of negotiating advance pricing agreements (APAs), in complex cases, the information required by HMRC to reach such a conclusion is likely to be quite involved. It may include, inter alia, financial and tax data illustrating value

chain profitability by legal entity, organisational charts and employee information including key role descriptions and responsibilities within each entity. This therefore goes considerably beyond traditional approaches of many transfer pricing studies, where the functions, risks and assets of only one side of the transaction are reviewed.

Businesses should act now to review their transfer pricing, applying a full value chain approach. Groups can then use the results to proactively engage with HMRC to demonstrate that no notification is required

under the diverted profits tax rules. Such engagement make take the form of a formal APA or alternatively via the Customer Relationship Manager (CRM). Where no CRM has been appointed, businesses should approach the central HMRC DPT team.

Furthermore, it is important to undertake such a two sided analysis as soon as possible as in our experience this is likely to result in a different conclusion regarding the right point in an arm's length range compared with an historic one sided analysis.

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EYG No. CM5318

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