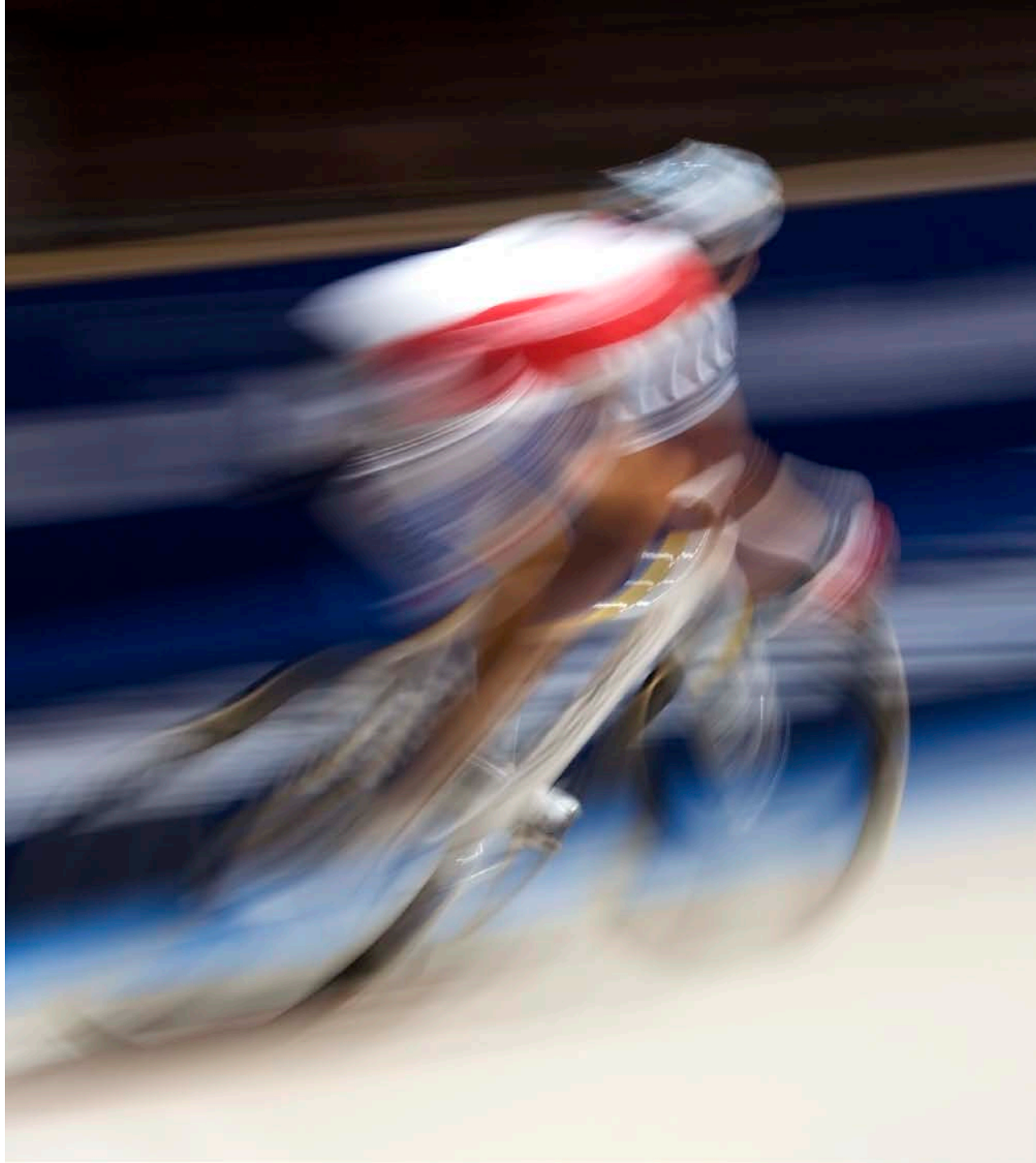




United Kingdom Diverted Profits Tax

Christie Buck
Renat Shklonik
Andy Wilde
Deloitte United Kingdom

March 1 - 4, 2015



Agenda

- Overview of the Diverted Profits Tax (DPT)
 - Artificial avoidance of a UK PE
 - Transactions involving a lack of economic substance
- Examples and case studies
- Action outside the UK and next steps
- Strengthening anti-avoidance – other UK measures
- Questions

Scope of Diverted Profits Tax (DPT)

Introduction

DPT – what is it and what's its purpose?

- A new UK tax that applies to companies in addition to corporation tax
- 25% tax rate on caught profits, effective from April 2015
- The Government's objectives include encouraging behavioural change, enforced with a penal rate and no treaty protection
- The current measure is unclear and introduces considerable uncertainty
- The DPT has potentially much wider scope than just the businesses intended to be taxed

Scope of DPT

- Will apply in two distinct situations:
 - 1) Foreign company has artificially avoided having a taxable presence in the UK, or
 - 2) A UK company or UK permanent establishment (PE) of a foreign company has transacted with a low-taxed entity that lacks economic substance.
- Requirement for activity (people) in the UK
- Will not apply to
 - Small or medium-sized enterprises
 - Situations with “only” loan relationships?

Situation 1

Artificial avoidance of a UK PE

Overview

- An entity (person) "carrying on an activity in the UK in connection with supplies of goods or services" made by a foreign company to UK customers
- "It is reasonable to assume" that the UK activity is “designed” so that the foreign company is not carrying on a trade through a UK PE
- Where there is either (or both)
 - **A tax avoidance (motive)**
 - **A mismatch, i.e. a reduction in tax paid, combined with a lack of substance**
- Exemption where UK sales are less than GBP 10 million

Tax avoidance

The main purpose, or one of the main purposes, of the arrangement is to avoid the charge to UK tax

Applied objectively, taking into account all of the facts

Mismatch

- “Material provision” (broadly, a transaction or series of transactions) between the foreign company and another connected party
- The provision results in an **effective tax mismatch** between the connected parties
- There is **insufficient economic substance**

Effective tax mismatch

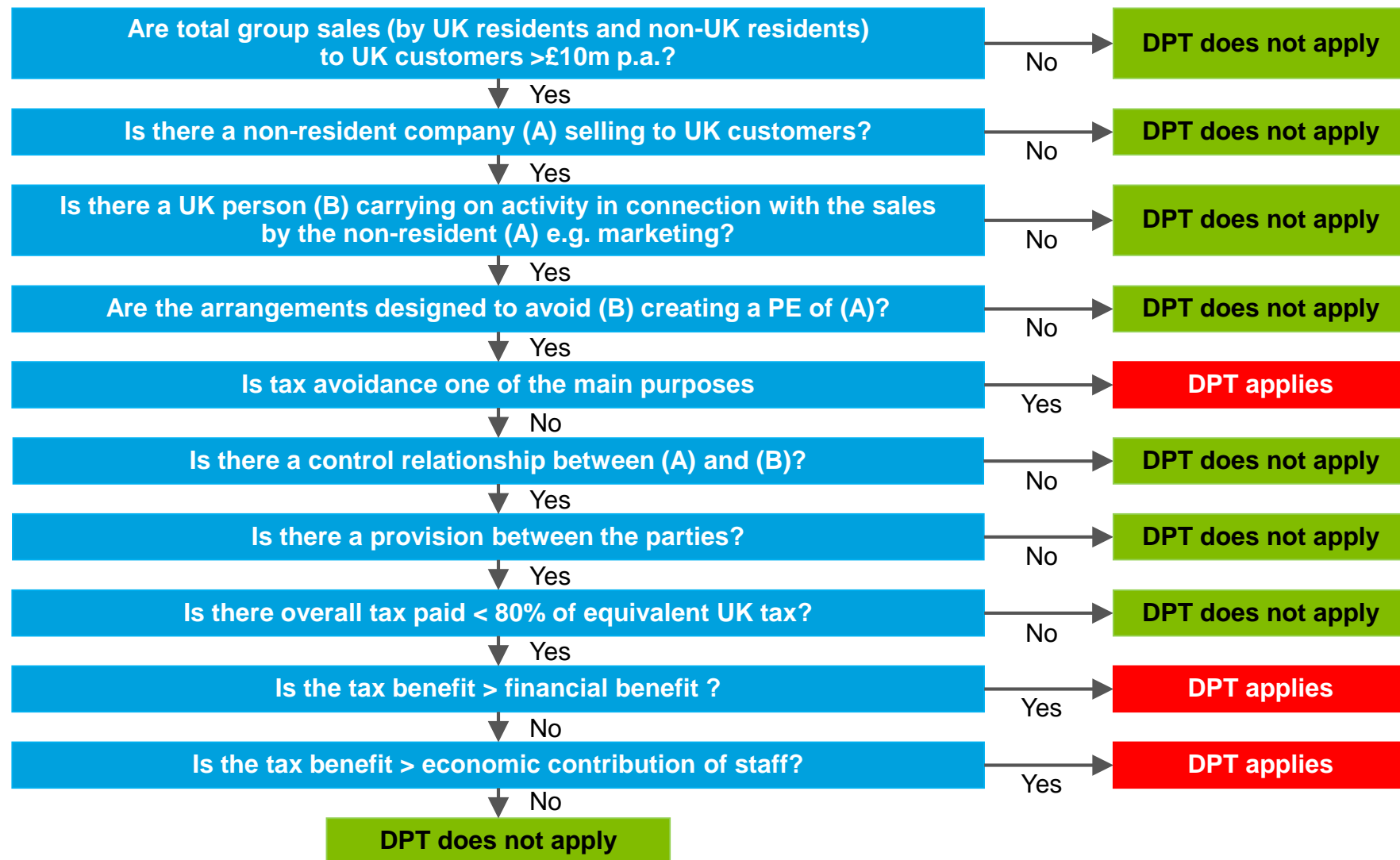
- The provision creates either an increase in expenses for which a deduction has been claimed or a reduction in income that otherwise would have been taxed
- There is a reduction in taxes paid, whether in the UK or elsewhere (“**tax reduction**”)
- Exclusion
 - The tax reduction is less than 20% of the tax that would have been paid (**80% payment test**)
- A tax reduction could result from
 - Different rates of tax, operation of a relief, exclusion of any amount from a charge to tax, etc.
- Utilization of losses is treated as tax paid for the purposes of the calculation

Insufficient economic substance

Either

- The financial benefit of the tax reduction is greater than any other financial benefit referable to the transaction or series of transactions
- The contribution of economic value of the functions or activities performed by staff of the entity is less than the value of the financial benefit of the tax reduction
 - **Management of outsourcing to third parties counts towards contribution, but not to group companies**

Artificial avoidance of a UK PE



Situation 2

Transactions involving a lack of economic substance

Recharacterisation of intragroup transactions involving a lack of economic substance

- **Provision** made between UK company and connected party (may or may not be UK resident)
- **Effective tax mismatch** between UK company and connected party, and
- The **insufficient economic substance** condition is satisfied

Effective tax mismatch

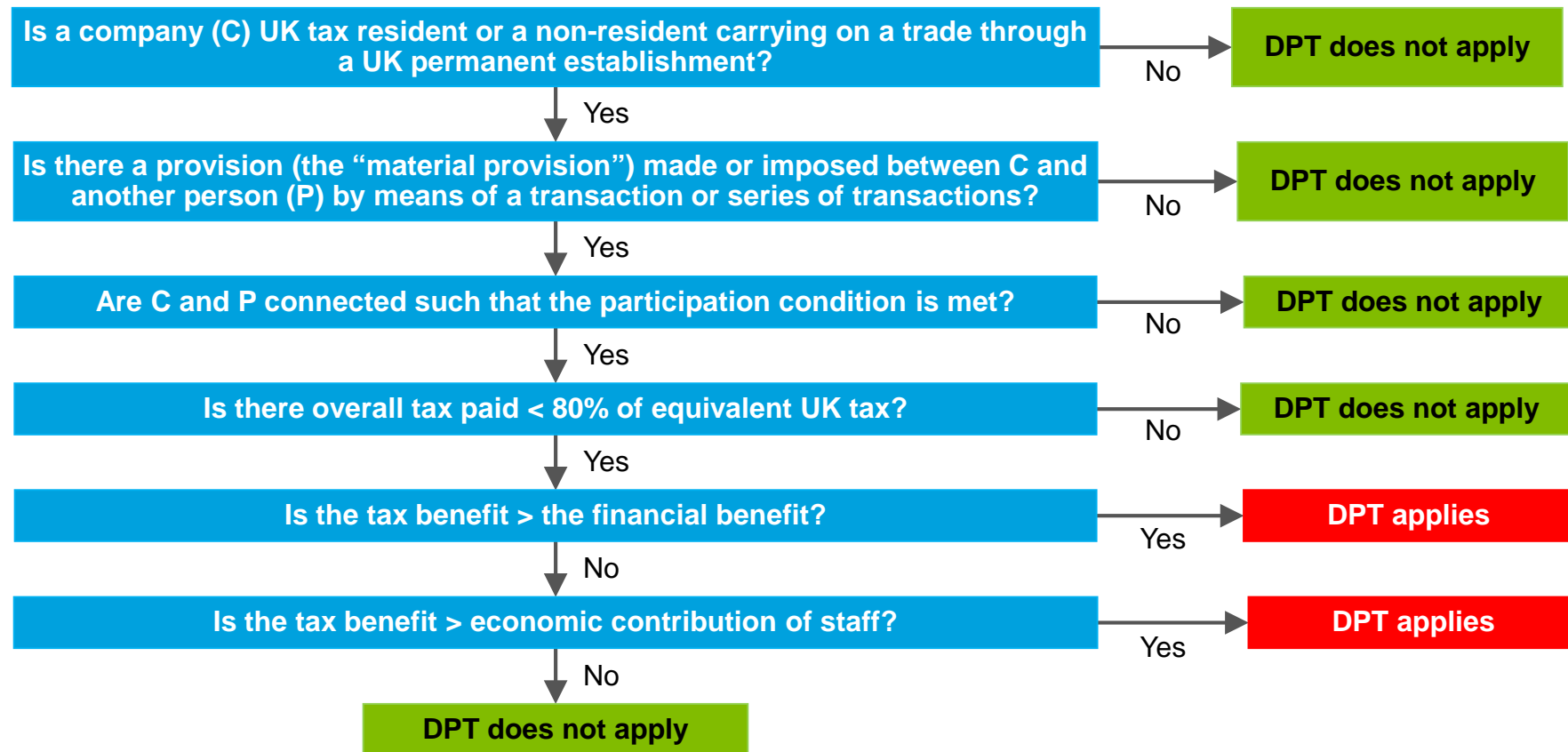
- The provision creates either an increase in expenses for which a deduction has been claimed or a reduction in income that otherwise would have been taxed
- There is a reduction in taxes paid, whether in the UK or elsewhere (“**tax reduction**”)
- Exclusion
 - The amount of tax paid is at least 80% of the corresponding reduction in UK tax (**80% payment test**)
- Tax reduction could result from
 - Different rates of tax, operation of a relief, exclusion of any amount from a charge to tax, etc.

Insufficient economic substance

Either

- The financial benefit of the tax reduction is greater than any other financial benefit referable to the transaction or series of transactions
- The contribution of economic value of the functions or activities performed by staff of the entity is less than the value of the financial benefit of the tax reduction
 - Management of outsourcing to third parties counts towards contribution, but not to group companies

Transactions involving a lack of economic substance



Notification and charging process

Process summary

Action	Time limit	
Notify HMRC	Three months after the end of the accounting period	NOTIFY
Preliminary notice issued by HMRC	Two years after the accounting period end (four years where no notification)	
Company representations	30 days from receipt of a preliminary notice	INITIAL CHARGE
HMRC issue charging notice	30 days from the end of the representation period	
Payment of DPT plus interest	30 days from issue of the charging notice	
Review of charging notice	12 months from the relevant payment date	ULTIMATE OUTCOME
Appeal by company	30 days from the end of the review period	

Duty to notify HMRC

- Avoidance of UK PE
 - The foreign company is not carrying on a trade in the UK through a PE as a result of a connected party's activity
- Lack of economic substance
 - The financial benefit of the tax reduction must be significant relative to any other

Initial charge

- Best judgement estimate by HMRC
- Presumption that inflated expenses create the tax mismatch – disallowance of 30% of the expenses in calculating the DPT
- No requirement to consider the arm's length position, but will be based on the facts and circumstances

Ultimate charge

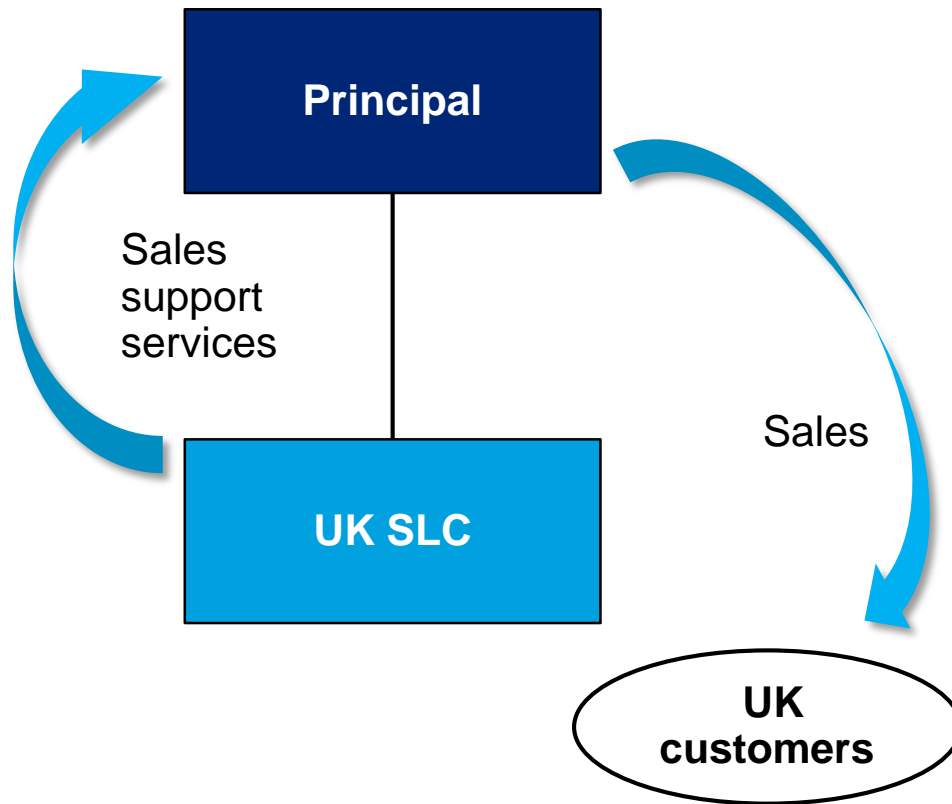
- Taxable diverted profit is the amount it would be just and reasonable to assume would be the chargeable profit had there been a UK PE
 - Negation of effects of excessive expenses flowing through to low-tax jurisdictions without adequate substance
- Taxable diverted profit is the amount due if arm's length principles were applied
 - Substitution of an **alternative provision** for the actual provision
- Credit given for UK, overseas or withholding tax suffered on profits

Examples and case studies

HMRC view

- Aimed at “**aggressive** tax planning that erodes the UK tax base through diversion of profits”
- **BUT** examples provided in guidance imply a much broader application and current draft legislation is certainly broader

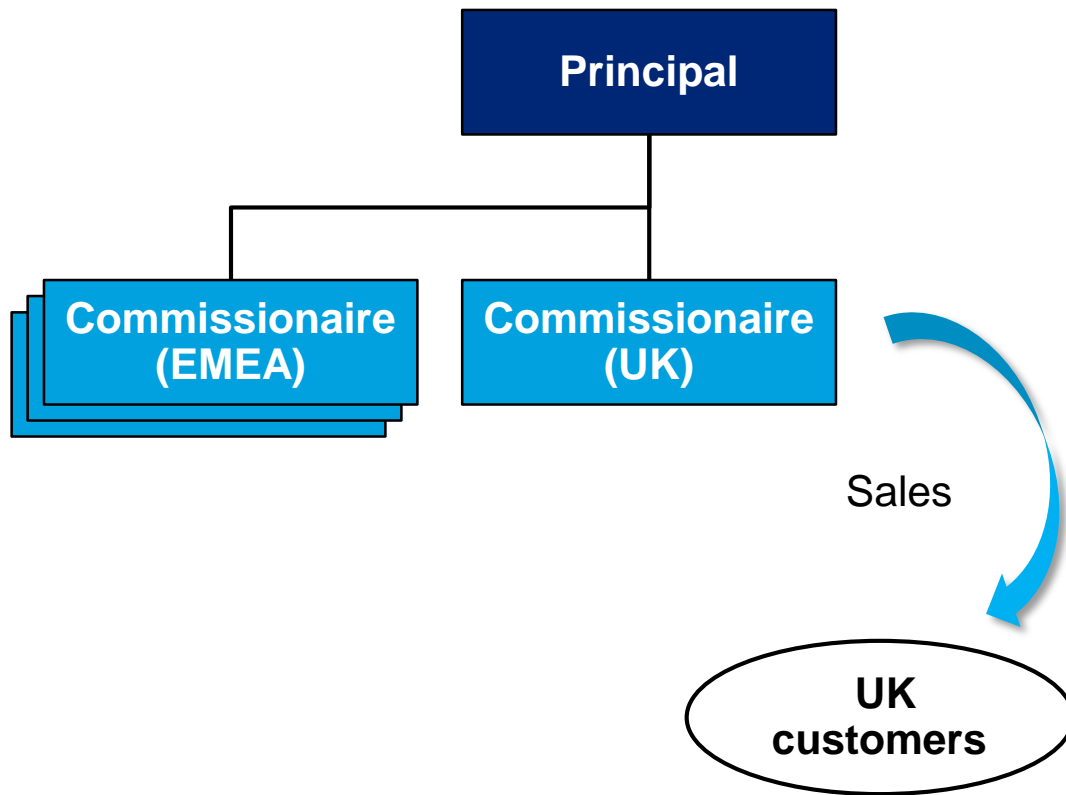
Example 1



Background

- Principal makes sales directly to UK customers
- Principal does not currently have a taxable PE in UK
- UK SLC provides sales support services to Principal, including meeting customers and assisting with contract negotiation but does not conclude contracts with UK customers
- What if no involvement with contract negotiation...?

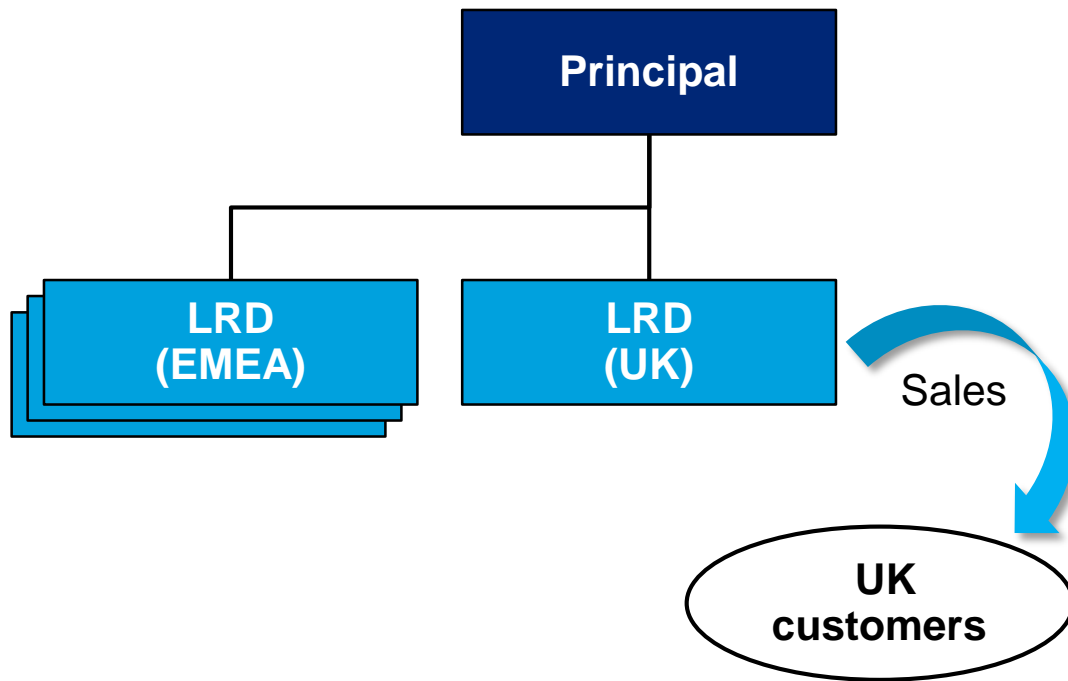
Example 2



Background

- UK Commissionaire acts in its own name but on behalf of Principal
- Principal enters into contracts with customers in UK and across EMEA
- Principal does not currently have a taxable PE in UK or other EMEA jurisdictions

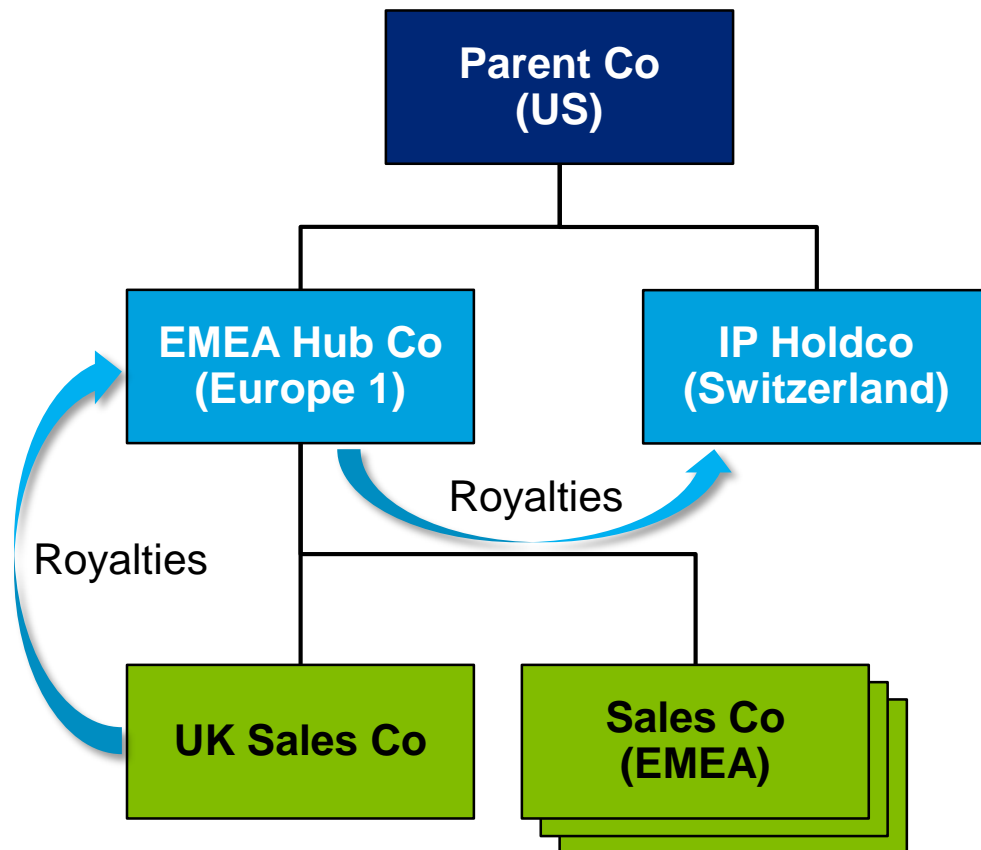
Example 3



Background

- LRD acts in its own name and on its own behalf, entering into contracts with UK customers
- Principal takes material economic risks and remunerates UK LRD on an arm's length basis
- Principal does not currently have a taxable PE in UK or other EMEA jurisdictions

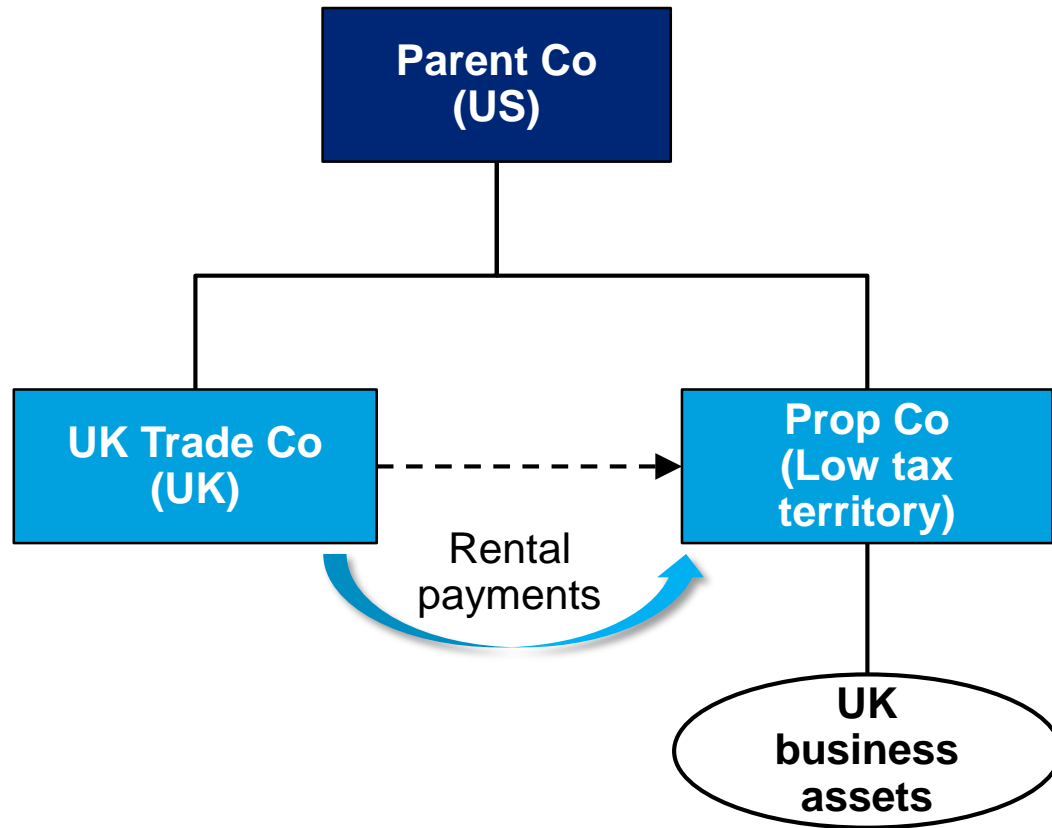
Example 4



Background

- IP Holdco owns Group's non-US IP, with contract R&D undertaken in local Sales Co's
- EMEA Hub Co licenses IP and sub-licenses to Sales Co's

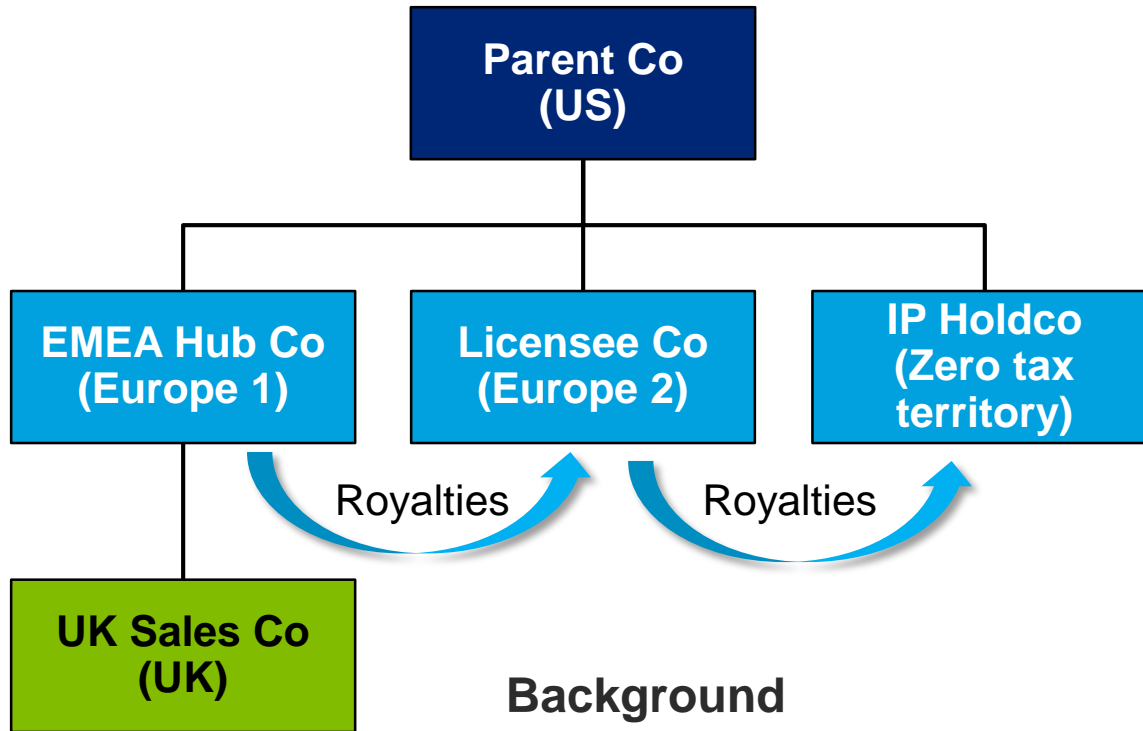
Example 5



Background

- UK Trade Co requires funding for business assets
- Parent Co provides funding to Prop Co, which acquires the assets
- Assets are leased to UK Trade Co in exchange for rental payments

Example 6



Background

- Europe 1 and Europe 2 have a beneficial tax treaty
- Europe 2 does not levy WHT on royalty payments
- UK Sales Co acts in its own name and on its own behalf but receives a cost-plus return from EMEA Hub Co

Just the Brits?

Next steps

Business next steps

- Consider the application of rules to entities and work through detailed application
- Obligation to notify?
- Consider commercial and practical consequences of supply chain changes, if appropriate
- Substantive enactment before March 31, 2015, with further guidance before this
- Quarterly reporting and FIN48 considerations
- Ongoing uncertainty
 - Is it an income tax?
 - Is the provision sufficiently quantifiable?
 - Deferred tax implications
- Engagement with HMRC?

Strengthening anti-avoidance

Strengthening anti-avoidance

Other UK measures

- Shifting practical stance from HMRC on unallowable purpose, particularly in inbound debt situations
 - No change in the law
 - Some Tribunal cases which established some principles HMRC see as helpful, but some which are helpful to the taxpayer
 - Practical importance of “just and reasonable” apportionment of deductions, and comparator transactions
- GAAR/Government procurement rules
- Introduction of a broad-based anti-avoidance rule for loans and derivatives
 - Very broad scope
 - Likely to be applicable to arrangements entered into on or after April 1, 2015
 - Uncertainty around application (e.g., loss utilisation or changing timing of deductions)

Strengthening anti-avoidance

Other UK measures (cont'd)

- Impact of the BEPS Hybrids paper on UK financing
 - CFC anti-avoidance (for UK headed groups)
 - Applicable to accounting periods beginning on or after January 1, 2017

Questions and answers

Please remember
to complete your
evaluation



Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte has in the region of 200,000 professionals, all committed to becoming the standard of excellence.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the “Deloitte Network”) is, by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2015. For information, contact Deloitte Touche Tohmatsu Limited.