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Diverted Profits Tax Client Briefing

1. Summary

1.1 The United Kingdom (U.K.) Government has announced that a new tax will be levied with effect from 1 April 2015. Diverted profits tax (DPT) will be charged at 25 percent of the amount of profits the legislation deems to have been diverted from the U.K. (a) through entities, or by means of transactions, including a U.K. corporate taxpayer that deliver effective tax mismatch outcomes without sufficient underlying economic substance, or (b) as a result of planning designed to avoid trading in the U.K. through a U.K. permanent establishment.

1.2 *Taxing effective tax rate (ETR) mismatches that are not supported by economic substance*. Corporate taxpayers established in the U.K. are at risk of DPT applying with respect to related party transactions (other than debt financing) featuring an effective tax mismatch that is not justified by the economic substance of the transaction or of the parties. This is likely to be most relevant to U.K. resident companies purchasing from or selling to certain related parties cross-border (*e.g.*, arrangements involving limited risk distributors, payments to a centralised product buyer/supplier or intangible property holding company). Generally, profits subject to DPT are pricing adjustments that have not been taken into account in the U.K. corporation taxpayer's tax return; this could be seen as a 5 percent surcharge for failing to set an accurate transfer price. If it is reasonable to suppose a provision of the transaction (*e.g.*, contractual shifting of risk away from the U.K. entity) would not have been made absent the effective tax mismatch, profits are recalculated on the basis of the provision that it is "just and reasonable" to assume the provision would have been made absent the effective tax mismatch.

1.3 *Taxing the avoided permanent establishment*. A "just and reasonable" allocation of profit will now be required in respect of activities carried on in the U.K. (including by an affiliate) in connection with supplies of goods or services to customers in the U.K. by a non-U.K. resident company, subject to certain exceptions. That allocation is then charged to DPT. This rule is likely to be most relevant to companies involved in the e-commerce and financial services sectors (save in the context of pure debt financing). The U.K. may be offering an incentive to affected groups to establish a taxable presence in the U.K. so that the relevant profits are to subject to corporation tax at 20 percent rather than face the higher DPT rate on profits allocated to those U.K. activities for DPT purposes. Affected groups who misjudge the application of the DPT rules and file on the basis that they are not within the scope of any U.K. tax could face a very significant increase in effective taxation.

1.4 The process under which DPT is charged puts the cash flow disadvantage firmly on the taxpayer: The deadline for payment is short and strict (30 days following receipt of a charging notice from the U.K. tax authority (HMRC)),

there is very little opportunity meaningfully to dispute any assessment prior to payment being required and HMRC is entitled to charge estimated and artificially inflated amounts of DPT at the outset that may be adjusted subsequently.

1.5 Multi-national enterprises with (i) sales into the U.K. by non-U.K. resident companies in excess of £10 million, or (ii) U.K. resident group companies or group companies with an existing permanent establishment in the U.K. that undertake related party transactions (other than debt finance), should therefore urgently review their existing arrangements in light of the proposed legislation and consider in particular whether they are or can be made more robust or whether to establish or consolidate their U.K. presence within the charge to corporation tax in order to reduce the risk of DPT being charged.

2. Background

2.1 On 3 December, George Osborne, Chancellor of the Exchequer, published the Autumn Statement 2014 announcing that DPT would be introduced to "*counter the use of aggressive tax planning to avoid paying tax in the U.K.*". The themes of the chancellor's speech to the Conservative Party conference in September 2014 implied that action would be taken in the arena of cross-border taxation. However, the scope of DPT had neither been announced nor publicly consulted upon prior to the Autumn Statement.

2.2 DPT is billed as a revenue-raiser but is only expected to yield £1.36 billion over the next five years, according to the figures published with the Autumn Statement 2014. The timing of the introduction of DPT — well in advance the U.K. general election on 7 May 2015 — may also indicate that this is an area in which the Government wanted to be seen to have taken action before starting to campaign.

2.3 Draft legislation in respect of DPT was published on 10 December 2014 along with explanatory notes. Draft HMRC technical notes are also available at this stage, and these are expected to form the basis of HMRC's DPT guidance in due course. The discussion below is intended to provide you with an overview of the draft legislation, notes and guidance as well as our initial reactions.

2.4 There is now a formal period of consultation in respect of the legislation lasting until 4 February 2015. It is unlikely in our view that the underlying policy will change as a result of submissions received during the course of the consultation, although this process will provide an opportunity to make technical representations as to the operation of the provisions as drafted.

2.5 Based on past practice, the act of Parliament that would pass DPT into law may not be finalised until June or July 2015, although it is clear that HMRC's intention is that DPT will have effect from 1 April 2015. However, it is conceivable that the U.K. Government might seek to pass DPT into law earlier, *e.g.*, before the general election in May 2015. Whatever the exact timing, it is highly likely that the legislation will be enacted and will apply effective April 2015.

This note should not be read as bespoke advice or as our opinion in connection with the application of DPT to any specific circumstances. We would be delighted to assist you in reviewing whether and how DPT will impact your particular group and arrangements.

3. General outline of DPT

3.1 DPT is charged at a rate of 25 percent by reference to taxable diverted profits of a company after 1 April 2015. This is in contrast to the mainstream rate of U.K. corporation tax which is expected to be 20 percent from April 2015. Diverted profits are treated as arising:

(a) pursuant to Section 3 to a company resident in the U.K. for U.K. tax purposes (and to a company currently carrying on a trade in the U.K. through a U.K. permanent establishment) (UKco) under certain related party arrangements which the legislation deems to involve a tax mismatch and to lack economic substance. This section appears aimed at distributor arrangements and other buy-sell transactions involving at least one related U.K. counterparty; and

(b) pursuant to Section 2 to a non-UKco if any person (A) is carrying on activity in the U.K. (including through an affiliate) in connection with supplies of goods or services by a non-UKco to customers in the U.K. and it is reasonable to assume that any element of the arrangements:

(i) is designed to ensure that non-UKco is not treated as carrying on a trade in the U.K. through a permanent establishment in the U.K. by reason of the activities of A; and

(ii) either involves related parties, gives rise to a tax mismatch and lacks economic substance or has a main purpose of avoiding a charge to U.K. corporation tax.

This section appears to be aimed at the e-commerce and financial services sectors (other than lending) as well as IP-rich retail businesses.

It is theoretically possible that a single arrangement could involve DPT charges under both sections.

3.2 The charge to DPT applies only to companies that are, or are part of, large enterprises[1] and does not apply to individuals and other persons that are not companies (*e.g.*, trustees).

3.3 Companies, whether U.K. resident or not, are required to give notice to HMRC in respect of any accounting period for which the charge to DPT might be applicable based on certain modified assumptions (an s13 notice). The modified assumptions appear to be intended to capture all potentially applicable situations and to leave judgment calls (see discussion below on what may be "*reasonable to assume*") solely to HMRC. Given the breadth of the legislation and the possible uncertainties as to its application, a conservative approach will likely be to give an s13 notice if there is any doubt whatsoever. Tax-geared penalties can be imposed for failing to give s13 notices[2].

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1 Small- and medium-sized enterprises (being enterprises with fewer than 250 employees, annual over of less than €50 million and a balance sheet total of less than €43 million) are expressly excluded.

2 If deliberate and concealed, a failure to give notice could attract a penalty of up to 100 percent of the tax at stake.

3.4 However, even if a s13 notice is given, the amount of DPT chargeable is assessed by HMRC and not self-assessed by the taxpayer. An outline of the process which HMRC must follow to charge DPT is set out below (under *Process for charging DPT*).

4. Diverted profits of a UKco: ETR mismatches not supported by economic substance

4.1 Arrangements to which a UKco is party fall within the scope of DPT under Section 3 if the following conditions are met:

(a) A provision (referred to in the legislation and below as the **material provision**) has been made or imposed as between UKco and another person (P) by means of a transaction or series of transactions.

This is a very broad drafting and a potentially far-reaching test. It appears to allow a substance-over-form approach to any transaction or series of transactions to which UKco and an affiliated person are party directly or indirectly[3]. This would, however, clearly apply to a situation in which UKco acts as a distributor of products it has purchased from a non-U.K. affiliate.

(b) One or more persons (including UKco and P) participate directly or indirectly in the management, control or capital of both UKco and P[4].

(c) The material provision gives rise to an effective tax mismatch outcome between UKco and P.

An effective tax mismatch outcome arises if (a) UKco's income is reduced or UKco's deductible expenditure is increased, and (b) the resulting reduction in UKco's liability to corporation tax is greater than the amount of any increase in P's liability to tax, and (c) the increase in P's liability to tax paid by P[5] and not refunded[6] is less than 80 percent of the reduction in UKco's liability to tax. The amount of the difference in (b) is referred to in the legislation and below as the **tax reduction**.

Based on corporation tax rates expected from April 2015, this means that if P pays tax (or would have paid tax but for loss relief) equal to less than 16 percent of the amount of UKco's reduction in taxable income or increase in deductible expenditure, there will be an effective tax mismatch outcome.

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3 U.K.co and P do not need to be direct counterparties; it is sufficient that they are involved somewhere along the series of transactions.

4 This test of participation is derived from the U.K. transfer pricing rules in Part 4 of the Taxation (International and Other Provisions) Act 2010 (TIOPA). Broader rules apply if the relevant provision relates to financing arrangements (arrangements in connection with debt, capital or other finance including providing or guaranteeing the same).

5 The outcome of the test is not adversely affected if P uses any form of loss relief rather than actually paying the increased tax liability.

6 Refunds for these purposes would include repayments or payments in respect of a credit for tax made to any person. Payments to shareholders of amounts calculated by reference to their share of the company's corporate tax liability, such as have historically been available in Malta, may fall foul of these limitations.

(d) The amount of the tax mismatch is not justified by reference to the economic substance of the arrangements.

The legislation considers that there is insufficient economic (non-tax) substance if one of two circumstances applies:

(i) The first circumstance presents if, for UKco and P taken together, the financial benefit of the tax reduction (defined above) is greater than any other financial benefit referable to the transaction(s) and it is reasonable to assume that the transaction(s) had been designed to secure the tax reduction. Points to note:

(1) Financial benefit is not defined in the legislation. However, it would appear that, if there is 100 of overall financial benefit, there will be sufficient economic substance if at least 50 is referable to matters other than the tax reduction. It is, however, unclear how to ascertain the amount of (non-tax) financial benefit. For example, in the context of a limited risk distributor arrangement, there is a clear financial benefit in selling the product and generating income even though the benefit of some of that income is passed back from the distributor to the supplier. On current drafting, it would also appear that "other financial benefits" could include tax advantages and benefits other than the tax reduction itself.

(2) The test refers to UKco and P taken together but does not expressly take into account any other person within the wider group. Accordingly, any financial benefit apparent only on a consolidated basis may not always be taken into account.

(3) The second limb of the test — it being reasonable to assume that the transaction(s) had been designed to secure the tax reduction — seems prone to becoming an area of disagreement between taxpayers and HMRC. The test is of potential concern for a number of other reasons: actual circumstances might not be taken into account; the test is at least arguably highly subjective[7]; and the reference to "design" in this context suggests that the taxpayer may not be entitled, even if it could do so, to order its affairs so that the tax attaching under the appropriate legislation is less than it otherwise would be[8]. It is not clear what evidence a taxpayer will require in practice to demonstrate that a transaction was not designed to secure the tax reduction. However, in our view, it would be unreasonable to impose artificial limitations on circumstances in which taxpayers may wish to seek internal or external advice. Merely seeking advice should therefore not amount to evidence of a "design."

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7 HMRC has previously expressed the view (in "Simplifying Unallowable Purposes Tests, Discussion Document," 31 July 2009) that "reasonable to assume" drafting allows for a transaction to "*be assessed objectively and the test can potentially penetrate purported subjective purposes which do not stand up to objective scrutiny*".

8 Or, at least, that if the taxpayer did so, he could be compelled to pay this increased tax (*pace* Lord Tomlin in *IRC v. Duke of Westminster* [1936] AC 1).

(ii) The second circumstance presents if any party to the relevant transaction(s) contributes less to the economic value of the transaction(s) in terms of the functions or activities that the staff of that person performs than the value of the financial benefit of the tax reduction, and it is reasonable to assume that the transaction(s) had been designed to secure the tax reduction. Points to note:

(1) The test seems to require that, for example, where a U.K. limited risk distributor purchases product from a related Irish manufacturer, the profits allocated to Ireland are justified by reference to people functions as opposed to, *e.g.*, intangible asset investments.

(2) As drafted, this test appears to require staff of each link in a chain of transactions to contribute greater functional or activity-based economic value to the series of transactions than the entire financial benefit of the tax reduction. This appears to be the case regardless of the significance or otherwise of the role that party performs.

(3) Economic value expressly excludes any value deriving from a reduction or elimination of a liability of any person to U.K. or non-U.K. taxes.

(4) *"Reasonable to assume"* standard — see above.

(e) The arrangements do not constitute solely debt financing.

DPT will not be charged under Section 3 in respect of provisions between UKco and P resulting from transactions that give rise only to loan relationships or matters treated as loan relationships. It is conceivable that existing domestic limitations, coupled with the anticipated introduction into U.K. tax statute of the outcome of BEPS Action 4 on limiting base erosion through interest deductions and other financial payments and Action 13 on hybrid instruments and entities[9], are considered sufficient protection for the U.K. tax base without bringing debt finance into the scope of DPT.

4.2 UKco's diverted profits subject to DPT under Section 3 will be calculated as follows:

(a) The general rule is that UKco's diverted profits for the period are any profits not accounted for as part of UKco's corporation tax return that result from the application of the U.K. transfer pricing rules to the material provision as between UKco and P. In practice, this will provide an additional 5 percent incentive to UKco to ensure that the material provision as between UKco and P is correctly priced.

(b) However, if it is reasonable to assume that the material provision as between UKco and P (*e.g.*, a contractual shifting of risk from the U.K.) would not have been imposed absent the effective tax mismatch outcome, UKco's diverted profits are equal to the additional amount of profits that would have been charged to corporation tax if the

9 A U.K. domestic consultation document to that effect was published as part of the Autumn Statement 2014 with a view to introducing additional legislation in connection with hybrid instruments and entities from 1 April 2017: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/382382/tackling_aggressive_tax_planning_hybrids_mismatch_arrangements_consultation_final.pdf.

effective tax mismatch outcome had not existed and an alternative provision (determined on a just and reasonable basis and without resulting in any additional effective tax mismatch outcome) had been imposed instead.

In practice, if a U.K. distributor is purchasing the same product on the same terms from multiple affiliates and some of those transactions involve no effective tax mismatch outcome, it is possible that the taxpayer could argue that no diverted profits exist (provided that the transfer prices are not called into question). However, if all or substantially all purchases involve mismatches, the diverted profit could be the difference between a limited risk distributor arrangement and a full risk distributor arrangement or, conceivably, all the profit of the selling affiliate above a cost plus amount on the U.K. sales.

5. Diverted profits of a non-UKco: "no permanent establishment" planning

5.1 Section 2 brings within the scope of DPT profits attributable to an "avoided" permanent establishment of a non-UKco. Put differently, subject to certain exceptions, DPT will be charged on profits that would have been attributed to a permanent establishment of a non-UKco in connection with the activities of any person in the U.K. (including of an affiliate) (referred to in the legislation and below as the **avoided PE**) carried on in connection with supplies of goods or services by the non-UKco to customers in the U.K. as if that avoided PE had in fact been a permanent establishment in the U.K. of the non-UKco through which the non-UKco's trade is being carried out.

5.2 A number of concepts used in Section 2 are not specifically defined for the purposes of DPT. For example, "activity" suggests a much broader concept than trade or business. It is not clear whether "customer" is limited to individuals or includes corporates and other persons, or whether it is limited unrelated parties, or whether related parties should also be treated as such for these purposes. The phrase "supplies of goods or services" would appear to be taken directly from a VAT statute and will require clarification as to where the boundaries are (if any) for DPT purposes between transactions that amount to a supply of goods or services and those that do not[10]. Also, the drafting of the statute does not make it clear whether it is the supply itself that must take place in the U.K. or whether the customer must be in the U.K. (or both) and, if so, what that will mean in practice. Although this would be unsatisfactory and a potential cause for uncertainty in practice, it is likely that HMRC will wish to avoid providing binding or exhaustive definitions of these matters in the statute and, accordingly, we would anticipate that this type of question should at least be addressed in guidance (although HMRC's current draft does not do so).

5.3 Further points to note in connection with Section 2 are described below.

(a) Not reasonable to assume that the arrangements are designed so as to ensure the absence of a U.K. permanent establishment of non-UKco?

Section 2 can apply only if it is reasonable to assume that any activity of the avoided PE or non-UKco is "designed" to "ensure" that non-UKco does not have a permanent

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10 For instance, would renting out office space, selling a capital asset or transferring a business as a going concern be treated as a supply of goods or services for DPT purposes?

establishment in the U.K. by reason of the activities of the avoided PE. The fact that there may also be commercial or regulatory objectives or constraints to the activity or limitation is irrelevant. It is likely that evidence of structuring to avoid a U.K. permanent establishment will include to whether, for example, non-UKco has in place guidelines or other similar internal measures to control and monitor its activities in the U.K.

It is not clear at this stage how far the legislation is intended to reach, although, on a plain reading, it appears potentially very broad in scope. For example:

(i) *Internet companies doing business from outside the U.K.* The legislation is clearly intended to apply to companies engaging in transactions with U.K. customers from other jurisdictions where the Internet company has some activities in the U.K. that are designed to avoid a U.K. permanent establishment.

(ii) *Offshore businesses with staff or representatives in the U.K.* Offshore businesses that engage U.K.-based personnel to source or broker sales on their behalf or that send personnel (*e.g.*, to meet with clients or prospective clients) may until now have sought to impose strict parameters and behavioural protocols in respect of activities that can be undertaken in the U.K. Permitted activities in the U.K. will normally include only those which are expected not to result in the non-UKco carrying on a trade in the U.K. through a U.K. permanent establishment as a result. In particular, it may be the case that terms of business are discussed or negotiated with U.K. customers subject to formal sign-off or approval offshore by the non-UKco. It would appear that businesses operating on this model will be within the scope of DPT by reason of Section 2 subject to the other exceptions described below.

(iii) *U.K. investment advisors to offshore managers*. Could the activities of a U.K.-based investment advisor to an offshore investment manager with direct or indirect U.K. clients cause the investment manager to be liable for DPT? Would the fact that the advisor's services are merely advisory and do not extend to execution be capable of making it reasonable to assume that the contractual structure was set up so as to ensure that the U.K. investment manager is not carrying on a trade in the U.K. through the U.K. investment advisor? Does it make a difference if the investment advisor's contract expressly stipulates (as is common practice) that the investment advisor is not authorised to conclude contracts or do business on behalf of the manager or the manager's clients? Such a provision could be interpreted as a limitation imposed on the avoided PE which is designed to ensure that the investment manager is not carrying on a trade in the U.K. through the investment advisor. However, if the U.K. investment advisor provides (non-execution) advice to the client directly and the client is treated as investing rather than trading for U.K. tax purposes, it should not be reasonable to assume that the advisory nature of the relationship should cause the client to come within the scope of DPT.

(b) No tax mismatch or U.K. corporation tax avoidance purpose?

In addition, in order for Section 2 to apply, it must be reasonable to assume either that there is an effective tax mismatch outcome as between non-UKco and a person related to non-UKco (not necessarily the avoided PE) referable to the relevant supplies of goods or services in the U.K. that is not supported by economic substance (the **mismatch condition**) or that arrangements are in place in connection with the relevant supplies with a main purpose of avoiding U.K. corporation tax (t**he tax avoidance condition**).

(i) *Mismatch condition.*

The mismatch condition under Section 2 follows the same pattern as Section 3 (see 4.1(c) and 4.1(d) above). As with Section 3, the mismatch condition does not apply in a debt financing context for the purposes of Section 2 either.

(ii) *Tax avoidance condition.*

At first glance, this condition may seem self-fulfilling: If it is reasonable to assume that the activity of non-UKco and the avoided PE is designed so as to ensure that there is no U.K. permanent establishment, could it ever not be reasonable to assume that there is a main purpose of avoiding corporation tax? In our view, one does not necessarily follow from the other. In considering whether it is reasonable to assume that the arrangements were designed to ensure the absence of a U.K. permanent establishment, all other factors are ignored (see above). The absence of U.K. permanent establishment may therefore be a purpose but not a *main* purpose if in fact more weight is to be attached to other factors. It could be inferred from this condition that HMRC recognises that there will be non-tax features in play as well when considering whether or not non-UKco wishes to develop a direct presence in the U.K.: for instance, non-UKco may be seeking to structure its affairs in such a way as to ensure that it does not develop a U.K. establishment for regulatory purposes.

(c) No U.K. permanent establishment through exemption under U.K. domestic law.

Section 2 does not apply if the activity of the avoided PE is such that the avoided PE is an agent of independent status acting in the ordinary course of business[11] (**AIS**) that is not connected to non-UKco or is related to alternative finance arrangements[12].

Avoided PEs that are brokers, investment managers and Lloyd's agents who are not currently treated as permanent establishments of their non-U.K. clients because they qualify as AIS under existing statutory exemptions will not give rise to a DPT liability for their non-UKco clients even if the avoided PE and non-UKco are connected. This is a sensible exception and one that will be especially welcomed within the financial services industry. However, if the avoided PE does not qualify for these

11 Within Section 1142 Corporation Tax Act 2010.

12 Within Section 1144 Corporation Tax Act 2010.

statutory exemptions, the avoided PE will not be treated as AIS if the avoided PE is connected with non-UKco.

(d) U.K. sales threshold not met.

Non-UKco will be excluded from the scope of DPT in any accounting period in which the total sales revenue of non-UKco and all its affiliates from goods and services sold to customers in the U.K. in an accounting period does not exceed £10 million. This threshold is calculated on a groupwide basis and is not limited to the activities of the avoided PE. The reference to sales revenue suggests that this will be an accounts-based test; it is not clear whether sale to related parties will be deemed to be at market value for these purposes.

5.4 Non-UKco's diverted profits subject to DPT under Section 2 will be calculated as follows. A "just and reasonable" amount of profits is attributed to the avoided PE (based on existing U.K. rules for attributing profits to permanent establishments of non-UKcos) as if the avoided PE were an actual permanent establishment of non-UKco.

5.5 How a "just and reasonable" amount of profit is determined is unclear. At a minimum, the amount would relate to what there would be allocated to a U.K. permanent establishment if the non-UKco carried on the relevant activities through a U.K. permanent establishment. That in turn invokes questions such as whether intangible assets owned by the non-UKco would be attributed to the U.K. permanent establishment or not. It remains to be seen whether planning to separate the ownership of intangibles in the non-UKco that could be taxed in the avoided PE could be effective to minimise the amount of profits that could potentially be treated as diverted; alternatively, non-UKcos may consider bringing the relevant part of the intangibles into the U.K. corporation tax net with a view to limiting the amount of profit deemed diverted.

6. Process for charging DPT: pay now, fight later

6.1 HMRC must issue a preliminary notice of chargeability to the relevant company within 24 months of the end of an accounting period in respect of which the company has given an s13 notice. If no s13 notice has been received by HMRC or if it is reasonable for HMRC to believe that the amount of DPT charged to or paid by the company for an accounting period is too low, HMRC is entitled to issue a preliminary notice up to four years after the end of the relevant accounting period. In practice, this is likely to mean that HMRC will always have four years within which to assess DPT.

6.2 The taxpayer is allowed 30 days following receipt of a preliminary notice to make written representations to HMRC. HMRC is not required to consider representations that do not relate to specific matters of fact at this stage: in particular, there is no requirement to consider arguments based on transfer pricing, on the attribution of profits to permanent establishments or to judgment calls (*e.g.*, whether or not it is "*reasonable to assume*" that the criteria for DPT are met).

6.3 Within 30 days following the end of the period allowed to the taxpayer for representations, HMRC must either give a charging notice or confirmation that no charging notice will be issued in connection with the preliminary notice in question. A confirmation that no charging notice will be issued at this point does not prevent HMRC from raising further preliminary

notices and, therefore, in effect reopening the matter provided the preliminary notice is raised within the applicable time limits (see above).

6.4 If a charging notice is issued, the taxpayer is required to pay DPT within 30 days. Payment of DPT cannot be postponed pending review or appeal. If DPT due from a company that is not a resident in the U.K. for U.K. tax purposes is not paid on time, HMRC has the power to require payment from certain other affiliated entities, from any existing U.K. representative of the company and from the person who is the avoided PE.

6.5 During the 12 months following the date on which DPT is required to have been paid (the **review period**), HMRC must review the total amount of taxable diverted profits charged on the company. The overall liability can be reviewed (up or down) as part of that process. As currently drafted, a company is only entitled to appeal to an independent tribunal in respect of DPT charging notices within 30 days after the end of the review period.

7. Comment and matters for further consideration

7.1 Compatibility

(a) It is clear and unfortunate that the process pursuant to which the DPT legislation has been prepared and provided does not comply in full with the U.K.'s Tax Consultation Framework[13]. There is unlikely to be any remedy for affected taxpayers for such a failure.

(b) The draft legislation and accompanying documentation do not clarify whether consideration has been given to the compatibility between DPT legislation and EU fundamental freedoms. To the extent multinationals operating in other EU member states are affected by DPT, this is a line of argument that will be worth exploring in detail.

(c) The OECD has not reacted publicly to DPT as yet. Despite styling itself as a leader within the OECD Base Erosion and Profit Shifting (BEPS) project, the U.K. has taken the type of unilateral action which the BEPS project was intended to discourage. Again, it is unlikely that this would afford affected taxpayers any remedy, but this action could have a disruptive effect on the OECD BEPS process going forward.

(d) There should be a real concern that this legislation could serve as both an incentive and a model for other jurisdictions to adopt similar legislation. Unless clearly coordinated, the result could be chaotic for multinational taxpayers.

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13 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/89261/tax-consultation-framework.pdf. This is not the first time that tax rules have been introduced in connection with a perceived transfer or shifting of U.K. profits overseas and without meeting the parameters of the Framework. Other rules include the prevention of profit transfers under total return swaps (announced on 5 December 2013) and the subsequent introduction of rules disregarding for corporation tax purposes any related party transactions that are in substance transfers of profits transactions motivated by U.K. tax avoidance.

7.2 Is DPT within the scope of current U.K. double tax treaties?

(a) If DPT is within the scope of current U.K. double tax treaties, it is likely the impact of the provisions will be significantly limited. There is no suggestion that that is the HMRC expectation; in fact, press reports suggest that the Government has "double Irish" structures (amongst other treaty jurisdiction based structures) in the crosshairs of this legislation.

(b) By analogy with existing case law concerning the U.K. CFC charge[14], it would first be necessary, likely on a treaty by treaty basis, to establish whether DPT conflicts with the terms of the treaty — in other words, whether the amount that is subject to the DPT charge is income in respect of which taxing rights have been renounced by the U.K. under the treaty. This would generally appear more likely to be the case in respect of DPT levied pursuant to Section 2.

(c) It would also be necessary to establish that DPT is a tax that is sufficient similar to the taxes covered by the relevant treaty to enable the treaty to operate. It is possible that HMRC may seek to argue, based on the preamble to many of the U.K. double tax treaties[15], that treaties cannot apply to facilitate "fiscal evasion" and that HMRC perceives fiscal evasion absent a DPT charge. It remains to be seen whether a court would agree with such an argument.

7.3 How will DTP interact and overlap with certain existing U.K. anti-avoidance rules?

(a) *Controlled foreign company rules*. There is currently no credit available against a DPT liability in respect of any controlled foreign company charge paid or payable by reference to the same profits. Although this may be a deliberate added disincentive of tripping the DTP rules, failure to allow a credit could clearly lead to double taxation.

(b) *Transfer pricing*. DPT chargeable pursuant to Section 2 appears to operate largely independently of transfer pricing (except insofar as transfer principles are applied to establish the just and reasonable allocation of profits to the avoided PE). As noted above, DPT chargeable pursuant to Section 3 will provide an additional 5 percent disincentive to U.K. corporation taxpayers in the event that any transactions within the scope of Section 3 are found to have been inaccurately priced.

(c) *General anti-abuse rule*. DPT will fall within the scope of the U.K. general anti-abuse rule. However, based on the documents published to date, it would appear that DPT is not covered by the Disclosure of Tax Avoidance Scheme rules (**DOTAS**). It seems likely that HMRC will seek to bring DPT within the scope of DOTAS in due course.

7.4 Is DTP a creditable tax for U.S. taxpayers?

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14 In *Bricom Holdings Ltd v. Commissioners of the Inland Revenue* 70 TC 272.

15 For example: "*Convention between the government of the United Kingdom of Great Britain and Northern Ireland and the government of the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital gains*" (emphasis added).

(a) The tax is likely to be a "separate levy" under the Section 1.901-2 regulations and thus judged on its own rather than as part of U.K. corporation tax.

(b) DPT charged pursuant to Section 2 seems likely to be creditable assuming it applies to an amount of the net income of a non-UKco and does not disallow (other than through transfer pricing adjustments) any material deductions of that company.

(c) DPT charged pursuant to Section 3 seems more problematic because it is in form taxing the income of an affiliate of a U.K. taxpayer. However, taxpayers subject to the tax can argue that the U.K. is really judging the income as properly earned by the U.K. entity and that the U.S. foreign tax credit rules do not second-guess such judgments where the voluntary payment provisions do not apply. Thus, as long as material deductions are not disallowed, strong arguments can be made that the tax on UKco is creditable.