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UK Government Announces New 25 Percent Diverted Profits Tax

Yesterday, the U.K. Government released draft legislation to be effective on 1 April 2015, which will impose a "diverted profits tax" (DPT) at 25 percent of the amount of profits deemed to have been diverted from the U.K. (a) through entities or transactions that result in an effective tax mismatch 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. The draft legislation and a paper discussing the legislation in detail are attached.

Highlights

Taxing Effective Tax Rate (ETR) Mismatches Not Supported by Economic Substance: The DPT will be imposed, subject to certain exceptions, on profits from certain related party transactions where (a) a U.K. company's income is reduced or its deductions are increased, (b) the resulting reduction in the U.K. company's corporation tax liability is greater than the amount of any increase in an affiliate's tax liability, (c) the affiliate pays tax equal to less than 16 percent of the amount of the U.K. company's reduction in taxable income or increase in deductions, and (d) the tax mismatch is not supported by the economic substance of the parties or the transactions. DPT will not be imposed under this section in respect of debt financing transactions.

Taxing the Avoided Permanent Establishment: The DPT will also be imposed on the "just and reasonable" allocation of profits in respect of activities carried on in the U.K. in connection with the supply of goods or services by a non-U.K. resident company to customers in the U.K., subject to certain exceptions. Multinationals with groupwide revenue from sales into the U.K. of less than £10 million will not be charged to DPT under this section.

DPT Applies to Large Companies Only: Small- and medium-sized enterprises are not within the scope of the DPT charge.

Process and Timing: The tax is assessed by the U.K. taxing authority and the deadline for payment is short and strict (payment is due 30 days following notice from the U.K. taxing authority). The U.K. tax authority (HMRC) is entitled to charge estimated and artificially inflated amounts of the DPT from the outset, subject to subsequent adjustment.

Key Takeaways

ETR Mismatches: Multinational companies operating in the U.K. through limited risk distributor arrangements, or making payments to a centralized product buyer/supplier or using intangible property holding companies located in low-tax jurisdictions, should assess their arguments against imposition of DPT in order to determine their ability to avoid application of DPT. There is currently limited information regarding application of DPT or the documentation that will be required in order to defend against the imposition of DPT.

Deemed Permanent Establishments: E-commerce companies, those in the financial services sector or IP-rich retail businesses operating outside the U.K. and whose profits are partially taxed in lower-tax jurisdictions than the U.K. should consider whether to restructure their operations before the April effective date or be in a position to support their defense against imposition of DPT.

Importance of Being Proactive: As there will be little opportunity to meaningfully dispute any assessment prior to payment of an assessed DPT being required, it will be critical for affected companies to develop their arguments against a DPT assessment and gather any supporting documentation in advance of any assessment.

Timeline to Enactment: The legislation is now formally under consultation until 4 February 4 2015; comments can be submitted to HMRC, but, in our view, this process is unlikely to result in changes to the underlying policy decisions that have led to DPT. Skadden intends to have a dialogue with members of HMRC and HM Treasury before the legislation is enacted and will be well positioned to advise our clients both during the consultation process and prior to enactment. 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. 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.

Creditability of DPT for U.S. Multinationals: The DPT is likely to be a "separate levy" under applicable Treasury regulations and thus judged on its own, rather than as part of the broader U.K. corporate income tax. DPT imposed on the "avoided PE" seems likely to be creditable assuming it applies to an amount of net income of a non-U.K. company and does not disallow (other than through transfer pricing adjustments) any material deductions of that company. DPT imposed on ETR mismatches seems more problematic because the DTR in form taxes the income of an affiliate of a U.K. taxpayer. However, as long as material deductions are not disallowed, strong arguments can be made that the tax on the U.K. affiliate is creditable.