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Diverted Profits Tax

The Diverted Profits Tax (DPT) legislation was been published within the 2015 Finance Bill on 24 March 2015 and will come into force from **1 April 2015** (Royal Assent is expected this week). DPT was initially introduced in the Autumn Statement, following which draft legislation was provided for technical consultation. The DPT will be a new tax at a rate of 25 percent (55 percent for ring fenced oil and gas companies) on diverted profits relating to UK activity. Following the technical consultation, a number of amendments were made to the discussion draft prior to it being published as legislation. The main changes are in relation to the obligation to notify potential liability, the extension of the charge applying to non-UK companies, and clearer wording on the charge applying to UK companies. The main changes have been considered in more detail below.

Summary of the DPT rules

- The DPT rate is 25 percent (55 percent for ring-fence companies).
- There are two types of charge. The first is on non-UK companies which are considered to have diverted profits from the UK by avoiding a UK taxable presence. The second is on UK companies which are considered to have diverted profits from the UK by involving entities or transactions lacking economic substance.
- Companies are required to notify that they may have a potential liability to DPT. HMRC will then issue a charging notice and the taxpayer must pay the tax charged before it can appeal. If no notification is made and DPT is chargeable, the company is subject to penalties.

Amendment to the DPT charge on non-UK companies avoiding a UK taxable presence

The draft DPT legislation released in December defined the charge by reference to non-UK companies which supply goods or services to UK customers. The rules have being amended to change the focus from 'sales to UK customers' to sales which relate to "UK activity". UK activity is defined as activity carried on in the UK in connection with supplies of services, goods, or other property by the foreign company in the course of its trade. Thus a non-UK company which does not sell to UK customers (or where sales to UK customers are below the de minimis level in the legislation) could now be within the scope of the DPT legislation, if there are sales which relate to UK activity and the conditions are met.

The legislation tests whether there is a person, the "avoided PE", carrying on activity in the UK in connection with supplies made by the foreign company. It applies where "it is reasonable to assume that any of the activity of the avoided PE or the foreign company or both 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…". (This wording has been changed from the previous version).

Where the conditions are met, the legislation will apply to attribute profits to the UK on branch attribution principles. The broad effect therefore is that the non-UK company will pay DPT on the part of its profits which are attributable to UK activity and not already subject to UK corporation tax (eg as a result of payments to UK service companies).

Changes to the charge on UK companies

Although the scope of the DPT charge to UK companies has not been altered significantly, it is clearer to understand. The legislation considers a provision made between a UK company and, for

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example, a group company in a low-tax jurisdiction. One target here is a group which has charged excessive amounts to a UK company so as to depress its taxable profits. A particular situation which is targeted is where the payment is made to a company with insufficient substance. However, the potential application is broader than this. It can apply to increase deemed UK income as well as reduce deductible expenses, and can potentially be invoked even where there is active substance in the foreign company, as described below.

The legislation includes an "insufficient economic substance condition". There was concern that the previous version used broad and undefined terms, and the amendments spell out a little more which companies are targeted. Of the three conditions that can trigger "insufficient economic substance", two relate more to business motive than to physical substance, but the third focuses on people functions. There are now two alternative conditions in relation to staff; if the arrangement is designed to secure the tax reduction, one of these conditions must be met in order for the charging provision not to apply. One condition considers the contribution of the staff of the overseas company in comparison to the tax reduction. There is a second new condition. This is that "the income attributable to the ongoing functions or activities of [the overseas company's] staff in terms of their contribution (ignoring functions or activities relation to the holding, maintaining or protecting of any asset from which income attributable to the transactions derives) exceeds the other income attributable to the transaction or transactions." Thus a UK company paying royalties to a group company which passively holds intellectual property is likely to fall within the scope of the legislation where the arrangement is designed to reduce tax via the royalty. The legislation continues to restrict this test to employees and officers of the company, and externally provided workers; representations had been made that it should be extended to cover seconded staff.

Notification requirement

The notification provisions are important because they start the process whereby HMRC can issue a charging notice. It was widely agreed during the technical consultation that the previous wording was too wide and would place a major compliance burden on taxpayers, potentially swamping HMRC in paperwork about companies which would not have any liability.

As a result of this, HMRC has made a number of changes to the notification requirement summarised below:

- The notification period has been extended for the first DPT accounting period (i.e. a period ending on or before 31st March 2016) to 6 months following the end of the accounting period. For all other accounting periods, the notification period reverts to 3 months.

- If it is reasonable for the company to conclude that no charge to DPT will arise, then there is no notification to HMRC required. (It should be noted here that there is a penalty for failure to notify).

- If the inspector has given confirmation that the company has supplied sufficient information to determine the DPT position, and the inspector has examined it, then notification is not required.

- If it is reasonable for the company to conclude that it has supplied sufficient information to determine the DPT position and HMRC has examined the information, then notification is not required.

- There is no requirement to notify HMRC if a company notified HMRC for the previous period, or was not required to notify and at the end of the notification period for the current period,

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and it is reasonable for the company to conclude that there has been no change in circumstances which is material to whether a charge to DPT may arise.

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