INTRODUCTION TO THE DIVERTED PROFITS TAX

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Introduction to the diverted profits tax

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Background

It was announced at Autumn Statement 2014 that a new tax would be introduced, known as the diverted profits tax (DPT) (see the Autumn Statement 2014 - corporate tax overview news item). The final legislation was introduced by FA 2015, ss 77 – 116 and Sch 16. The Government hopes that the introduction of the DPT will deter multinational groups of companies from implementing aggressive tax planning techniques which divert profits away from the UK, in an attempt to minimise the group's overall corporation tax bill.
HMRC, which is responsible for the collection and management of DPT, has published draft guidance on the operation of the DPT regime in the form of DPT: interim guidance. The draft guidance was last updated in March 2015 and is referred to throughout this note. It is possible that this guidance may be amended by HMRC prior to finalisation. HMRC has stated its intention to incorporate the interim guidance into the International Manual (INTM) in due course.
FA 2015, s 103

This guidance note helps readers to understand the basic principles of the DPT regime to enable them to ascertain whether a particular scenario is likely to attract a charge to DPT, with links to additional sources of information as appropriate.

Circumstances in which DPT may apply

A charge to DPT may be applied to the taxable diverted profits of a company for an accounting period if one or more of the three situations summarised below arises.
FA 2015, s 77(2)

(i) Charge on a UK company where entities or transactions lack economic substance (section 80 charge)

The first situation in which a charge to DPT could arise is where a provision is made or imposed between a UK resident company and a related person, as a result of which the UK resident company achieves a tax reduction significantly greater than any tax increase for the other person (in other words, there is a 'tax mismatch'), and it is reasonable to assume that the provision was designed to secure the tax reduction. The existence of this provision means that DPT could apply in cases where wholly UK based structures are involved, as opposed to multinational structures.

FA 2015, s 80

This is explored further in the DPT - entities or transactions lacking economic substance guidance note.

(ii) Charge on a non-UK company where entities or transactions lack economic substance (section 81 charge)

The second situation in which a charge to DPT could arise is where a non-UK resident company is trading in the UK through a permanent establishment (PE) and the first situation in (i) above would apply to that PE if it were a UK-resident company.
FA 2015, s 81

The definition of PE for this purpose is taken from CTA 2010, Chapter 2, Part 24. See also the Permanent establishment guidance note for further details on PEs.
FA 2015, s 114(1)

This is explored further in the DPT - entities or transactions lacking economic substance guidance note.

(iii) Charge on a non-UK company avoiding a UK taxable presence (section 86 charge)

Finally, a charge to DPT could also arise where a person is carrying on activity in the UK in connection with supplies of goods, services or other property by a non-UK resident company, and it is reasonable to assume that any of the activity of that person or the non-UK resident company (or both) is designed to ensure that the company does not carry on a trade in the UK for corporation tax purposes and, in connection with the supplies of services, etc either the main purpose of the arrangements put in place is to avoid corporation tax, or a tax mismatch is secured such that the total tax derived from UK activities is significantly reduced.
FA 2015, s 86

There is an exception from a charge arising under this provision if the UK-related sales are below £10 million or the UK-related expenses are below £1 million.
FA 2015, s 87

Please see the DPT - avoidance of UK permanent establishment guidance note for more details.

Entities that may be subject to DPT

The DPT legislation is primarily aimed at large multinational groups, although see (i) above for the potential application to UK / UK arrangements. However, it is commonly misunderstood that the DPT legislation does not really apply to small or medium sized enterprises (SMEs). The legislation states that if ***all*** the parties involved are SMEs for the accounting period, a charge to DPT will not arise due to the availability of an SME exemption. SME for this purpose takes the definition from TIOPA 2010, s 172, as is used for transfer pricing purposes (see also INTM412080). Whilst this definition is based on the EU definition (in Commission Recommendation 2003/361/EC), there is one key difference in that there is no 'grace' period. This means that if an SME falls within the definition of a large enterprise for a single accounting period it is treated as a large enterprise for that accounting period. Under the EU definition, SME status would be maintained until it qualifies as a large enterprise for two consecutive accounting periods.
FA 2015, s 114(1)

In practice, an SME involved in FA 2015, s 86 avoided PE arrangements (see above), could be caught by the DPT provisions, eg if it was a UK company providing services to UK customers of an offshore property development company, which is itself part of a multinational group. If the UK SME purely carried out activities in relation to the offshore multinational group company then the related arrangements could be within section 86.
A charge to DPT can also arise where one of the parties to the transaction is a member of a partnership. References to partnership include limited liability partnerships as defined in CTA 2009, s 1273, and an entity established under the law of a territory outside the UK which has similar characteristics to a partnership.
FA 2015, ss 112 and 114(1); DPT1200

The DPT legislation does not apply to a Lloyd's corporate member's profits from syndicate memberships and from premium trust fund assets which are declared in 2015 or a later year. See FA 2015, s 116 for further details.

Charging notice and other administrative matters

A charge to DPT is imposed for an accounting period by HMRC issuing a charging notice to the company in question in accordance with FA 2015, s 95. The notice must contain certain

details prescribed by FA 2015, s 95(5), such as the amount of the charge to DPT, which of the three scenarios described above forms the basis of the charge, the accounting period to which the charge relates, and who is liable to pay the DPT.
FA 2015, s 79(1)

Once the charging notice has been issued, HMRC must conduct a review of the amount charged. This takes place during the review period, which is the 12 months commencing the day after the period of 30 days following the date charging notice is issued. HMRC may issue one further charging notice during the 12 month review period, known as a supplementary charging notice, imposing an additional charge to DPT if necessary.
FA 2015, s 101

The legislation sets out fairly detailed provisions for the administrative procedures that must be followed for the purposes of DPT, which is not too surprising given that this is an entirely new tax. It is important that companies potentially effected by DPT become aware of these, eg the duty to notify HMRC that they may be within the scope of the DPT legislation, as there are penalties for non-compliance. HMRC are primarily seeking to identify significant diversions of profits from the UK, however the notification process is an important way of bringing even the smaller cases to the attention of HMRC. See the DPT administrative process guidance note for further details on the administrative aspects of the regime.

Rate of DPT

The amount of tax charged is the sum of:

- 25% of the amount of taxable diverted profits specified in the charging notice
- interest charged (if any) for the period beginning 6 months after the end of the accounting period to which the charge relates, and ending on the day the charging notice is issued (FA 2015, s 79(4)).

FA 2015, s 79
If the taxable diverted profits are adjusted ring fence profits or notional adjusted ring fence profits (applicable in the oil and gas industry), the rate of DPT applied is 55% rather than 25%.
FA 2015, s 79(3)

Given the decreasing rate of corporation tax in the UK, which is due to be as low as 18% by financial year 2020, there will be an increase in the differential rate between the two taxes.

Groups which may be effected by the DPT are likely to want more comfort on their exposure (or otherwise to DPT) as there will be a greater amount of money at stake. Early planning is therefore recommended.

Interaction with other taxes

The DPT takes priority over other taxes and as such, no deduction or other relief is allowed in respect of DPT when calculating income profits or losses for any other tax purpose.
FA 2015, s 99

If a company has paid corporation tax (or a foreign tax which is akin to corporation tax), a credit can be allowed against the DPT liability of the company, or of another company in relation to the same diverted profits.
FA 2015, s 100

These points are discussed further in the DPT administrative process guidance note.

Commencement and transitional provisions

The DPT legislation applies to accounting periods beginning on or after 1 April 2015. If an accounting period straddles this date, ie it starts before 1 April 2015 and ends after, the period must be notionally split into two separate accounting periods. Any apportionment of amounts between the two periods must be carried out on a just and reasonable basis. Interestingly, this is not a strict time apportionment basis, so there may be some scope for flexibility for companies which see fluctuations in their profits throughout the accounting period.
FA 2015, s 116(1)-(2)

For accounting periods which end on or before 31 March 2016, companies have a time limit of 6 months from the end of the accounting period within which they must notify HMRC that they are potentially within the scope of DPT, rather than the usual 3 months. It is hoped that this one off extension to the notification deadline will give those companies effected by the new tax some time to become familiar with the new legislation and to assess whether they are likely to be caught. These deadlines are explained in further detail in the DPT administrative process guidance note.
FA 2015, s 116(3)

DPT and GAAR

The General Anti-Abuse Rule (GAAR) applies to DPT. HMRC's interim guidance states at DPT2730 that the GAAR should not be raised with a taxpayer or their advisors until Counter-Avoidance have been consulted and have given their express approval to proceed. The definition of tax advantage at CTA 2010, s 1139 has been widened to include the avoidance or reduction of a charge to DPT. Please refer to the General anti-abuse rule (UK GAAR) guidance note for further information on the GAAR.

Further reading

The introduction of DPT and the relative speed at which this took place has been criticised by some commentators. Some believe that certain aspects of the DPT legislation have not been properly considered, in particular its interaction with EU law, double taxation treaties and the OECD's wider Base Erosion and Profit Shifting project. It is possible that the EU aspects of a DPT charge may come under the scrutiny of the European Court of Justice in the future, with particular reference to freedom of establishment and movement of capital. However, these cases may be limited given that it is possible to settle cases involving DPT through UK corporation tax return transfer pricing adjustments. For further commentary on these matters, please see 'FA 2015 analysis - Diverted profits tax: a detailed guide', by Sandy Bhogal in Tax Journal, 23 April 2015.

The range of businesses that could be affected by the DPT is wide reaching, and may include technology, luxury goods, banking and insurance industries. HMRC state in their interim guidance that the DPT can also apply to property transactions (see DPT1260 Example 1), as explored in 'Diverted profits tax and real estate', by Anne Fairpo in Tax Journal, 26 June 2015.
The full impact of the legislation remains to be seen.