

“The UK’s new ‘Diverted Profits Tax’: is this BEPS thought-leading or is the UK trying to go it alone?”

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# One Slide on BEPS

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- “Base Erosion and Profit Shifting” project announced in June 2012 and spearheaded by the OECD
- An ambitious international project recognising that domestic tax rules have not kept pace with globalisation and digitisation of business (and the ingenuity of MNCs and their advisers)
- A synchronised attempt to realign taxable profits with the place or places where key “value creation” and “significant people functions” of a business are located
- Closing off “clever” structures used to create “non-taxation” or “double deduction” structures
- Increased mandatory and shared reporting on where taxes are paid, where people are employed and where profits are made
- 15 interlinked Action Points at different stages of development

# The UK's Diverted Profits Tax

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- Or the “Google Tax” as it has been dubbed
- Two structures attacked:
  - Avoidance of UK PE
  - Use of entities which lack economic substance to exploit tax mismatches
- Announced December 2014 and in force from 1 April 2015
- Very complicated legislation (36 pages) and 88 pages of “interim” guidance notes
- But clearly a lot of thought has gone into it
- Guidance suggests only for use against “aggressive tax planning techniques” but arguably is much wider than this. Will be costly for businesses and has created uncertainty

# Use of Entities which Lack Economic Substance (1)

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- A UK person enters into arrangements with another connected person (most likely to be non-UK) which are not exclusively lending arrangements
- There is a “tax mismatch” outcome (see next slide)
- The other person satisfies the “insufficient economic substance” condition (see next slide) and it is reasonable to assume that the arrangement was designed to secure the tax reduction leading to the tax mismatch
- The parties are not both SMEs

## Use of Entities which Lack Economic Substance (2)

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- “Tax Mismatch” Outcome
  - very broadly the tax rate referable to the other person’s income from the transactions is less than 80% of the UK tax rate
- “Insufficient Economic Substance” Condition
  - very broadly the tax benefits of the overall arrangement exceed the non-tax benefits or the income attributable to the other person’s people functions’ contribution to the arrangement (other than holding or protecting valuable assets such as IP) is less than the other income attributable to those arrangements. (A very complex and potentially imprecise test)

# Avoidance of UK PE Structures (1)

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- Foreign trading companies making substantial supplies of “goods, services or other property”
- A person is “carrying an activity in the UK” in connection with those supplies
- That person is not an agent of independent status (and not connected with the foreign company) and “it is reasonable to assume that” the arrangement is designed to avoid creating a PE in the UK
- The “UK related sales revenue” of the foreign company is more than £10m per year and its “UK related expenses” are more than £1m, and the person and foreign company are not both SMEs
- The “mismatch condition” or the “tax avoidance condition” are met (see next slide)

# Avoidance of UK PE Structures (2)

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## ■ The Mismatch Condition

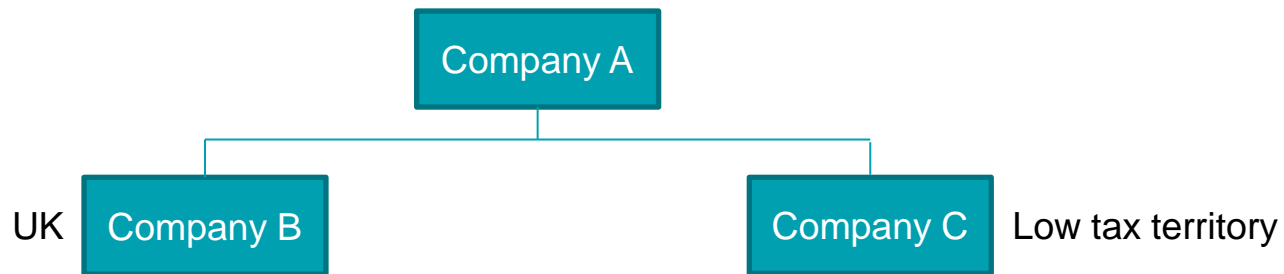
- Transactions (other than pure lending arrangements) occur between the foreign company and another person
- That other person and the foreign company are connected (wide test)
- There is an “effective tax mismatch outcome” as between those two parties (see before)
- The “insufficient economic substance condition” as regards the other person is met (see before)
- It is reasonable to assume that the transactions were designed to secure the overall tax reductions

## ■ The Tax Avoidance Condition

- Arrangements are in place the main purpose or one of the main purposes of which is to avoid or reduce a charge to UK corporation tax

## Example 1 of DPT (use of entities which lack economic substance)

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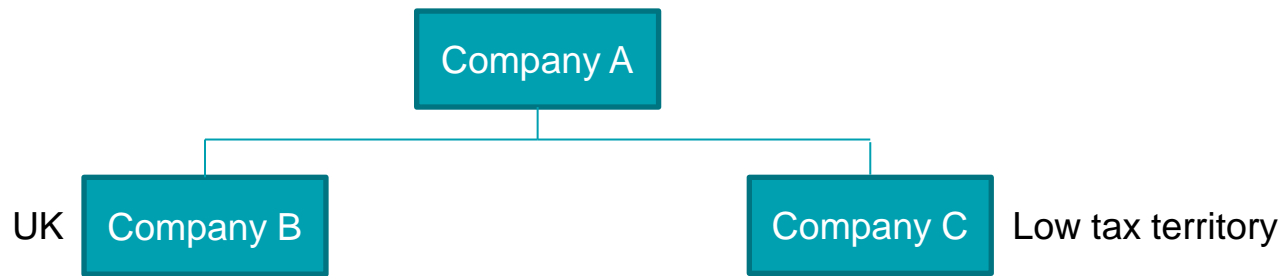


- Company B wants to invest in plant and machinery for its UK trade
- Company A injects equity capital into company C which uses this to buy the machinery
- Company C leases the machinery to Company B at arm's length rates, reducing Company B's taxable profits
- Company C has no staff and only performs routine administration
- There is a connection between the parties and a "tax mismatch" and Company C has "insufficient economic substance"
- May well be reasonable to assume that this has been designed to achieve the tax mismatch
- DPT applies by assuming that Company B had purchased the machinery itself here (so say the UK tax authorities)



## Example 2 no DPT (use of entities which lack economic substance)

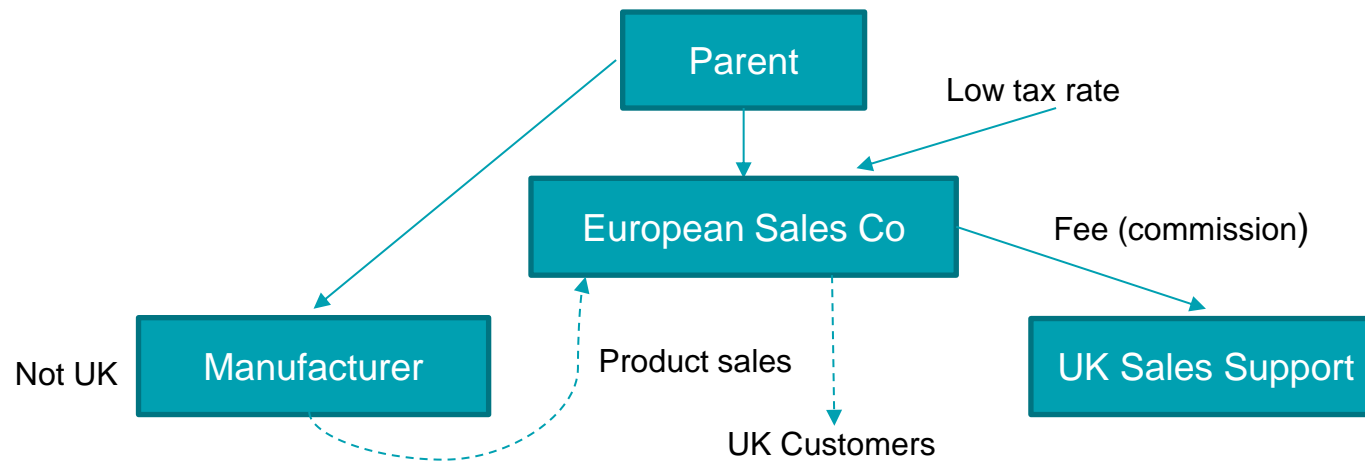
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- Company A owns worldwide IP
- Company B produces goods for sale
- Company C provides technical and admin support in return for a fee from Company B
- Crucially, Company C has local skilled staff and the fee is arm's length
- Probably ok here as arm's length and "insufficient economic substance" condition not met due to local skilled staff (according to the UK tax authorities)

## Example 3 of DPT (avoidance of UK PE)

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- From the facts determined that there is a “contrived separation of the conclusion of contracts from the selling activity and the process of agreeing terms and conditions” ie the requirement for the (low tax) European Sales Co to conclude the contracts is deliberately intended to limit the activity which takes place in the UK (which is substantial)
- Here the UK Sales Support entity is taxed as if it were a PE on the conclusion that the tax avoidance condition is met
- Compare where the European Sales Co takes a much more direct role in negotiation, promotion, advertising, sponsorship, managing major customers globally and everything at arms length

## DPT: Administration, Collection of Tax and Determination of DPT Payable

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- Not self-assessed but a complex and time-consuming advance notification process by the taxpayer with the UK tax authorities
- UK tax authority estimates the DPT and this is payable within 30 days, may subsequently be reduced but you must pay the estimated tax first
- Avoided PE – primary taxing amount is the amount of tax payable on the assumption that you had created a PE
- Use of entities which lack economic substance – transfer pricing methodology based but can re-characterise the whole arrangement and assume all income was not “diverted” at all overseas
- An additional punitive charge can effectively arise if there are “inflated expenses”
- 25% tax rate on diverted profits (NB single corporation tax rate in UK of 20% now)
- Others with a connection with the UK can be liable too (including the “avoided PE”)
- Penalties charged for non-compliance

## DPT some observations

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- UK tax authorities have made it clear that the DPT can apply to offshore property structures (“OpCo/PropCo” structure)
- Despite extensive protest it is now in force (is there an election soon by any chance?)
- Additional tax estimated is modest suggesting that the view is that this will act mainly as a deterrent
- There is a real question as to whether the DPT is EU compliant (is it targeted only at “wholly artificial arrangements” as per *Cadbury Schweppes* ECJ case?) and DTT compliant (is it a tax which is “substantially similar” to UK corporation tax – clearly designed not to be – and do the UK’s DTTs apply here anyway and/or is there an effective treaty override here?)

# DPT vs BEPS

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- Avoidance of UK PE is a blueprint for Action 7 (preventing the artificial avoidance of PE status)?
- Use of entities which lack economic substance a blueprint for Actions 8-10 (assuming that transfer pricing outcomes are inline with value creation)?
- Dangers of UK “going it alone” and others following? Double taxation?

# DPT vs BEPS

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**Senator Ketter:** Thank you. I now want to move to the UK's proposed diverted profits tax. What is the OECD's view in relation to that?

**Mr Saint-Amans:** It is an embarrassed view, I must say. We have sympathy for the need to move and there is an electoral context, if I understand correctly the situation in the UK, where the government, which has been very instrumental in supporting BEPS in raising the profile of this project, wanted to show that it was acting very, very quickly even before the time line of the BEPS project, which is after a very important electoral date in the UK. So on the one hand there is sympathy; on the other hand, as I tried to explain earlier, unilateral actions are not exactly in the sense of what we are trying to develop, which is, 'Let's wait for a comprehensive package and then countries will decide'. You are sovereign; you will decide what to do. But you will be better informed with better instruments and with a lesser risk of having disruptive actions, which might push other countries, like Australia, to take unilateral measures, which are not that great when you are negotiating a multilateral package.

**Senator Ketter:** Are you aware that the Australian Treasurer has indicated he will introduce a diverted profits tax in the next budget?

**Mr Saint-Amans:** we read the press and also talk to our Australian colleagues.

**Acting Chair:** That is very good to know!

**Senator Ketter:** Can I press you to say what you think of those plans?

**Mr Saint-Amans:** I can repeat my previous response, which is a diplomatic response but which reflects also what we think. Again, we have sympathy for that. We tend to think that unilateral measures will be better after we have completed the action plan, but countries are sovereign and it is for them to decide what to do.

*[From 9 April 2015 Economic References Committee in Australia – quote by Mr Pascal Saint-Amans Director for Tax Policy and Administration OECD]*

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Questions/Comments?