This article provides a summary of the main Diverted Profits Tax rules. In addition to analysing the rules, it also highlights some of the key challenges and practical difficulties in applying them.

1. Introduction

This article will provide a summary of the main Diverted Profits Tax (DPT) rules. These are broadly split into three categories: the qualifying conditions of the legislation, the calculation of the diverted profits and the resolution of DPT. In particular, the authors will highlight some of the key challenges and practical difficulties in applying the rules.

The DPT regime commenced on 1 April 2015, after initially being proposed by the UK government in the 2014 Autumn Statement and a period of discussion on the draft rules. For companies with 31 December year ends, the first period to which the DPT applies is therefore 31 December 2015. Where companies notified HMRC that they were potentially within the scope of the DPT legislation, the two-year window that HMRC has to issue a DPT charging notice closes on 31 December 2017.

A key feature of the DPT is that rules operate as a separate tax regime from the UK corporation tax or income tax and, per the HMRC guidance notes, DPT is “designed to counter the use of aggressive tax planning techniques used by multinational enterprises to divert profits from the UK.” Notwithstanding the “Google tax” epithet granted to the regime by the media, which implies a focus on the technology sector, the legislation can apply to all industries and sectors. The rules also have other novel features and are potentially far-reaching in their application.

It is worth remembering too that the DPT was introduced before the publication of the OECD’s final BEPS recommendations in October 2015. The UK government said at that time that the DPT was broadly complementary to the objectives of the BEPS initiatives in that the DPT rules aim to tackle erosion of the UK tax base in situations where groups (i) seek to avoid a permanent establishment in the United Kingdom or (ii) use arrangements or entities lacking economic substance.

Initially, there was speculation from commentators that the DPT regime might have a relatively short lifespan as the UK government introduced further BEPS-compliant legislation. However, to date, there has been no suggestion that this will be the case. As the authors discuss later, DPT appears to be increasingly embedded in HMRC’s approach to the way it reviews the role of the UK operations of multinational groups.

The DPT rules2 levy a 25% tax on “diverted profits” generated on or after 1 April 2015 and the tax applies to broadly two scenarios where there are:

- entities or transactions lacking economic substance, section 80/81 – a UK company or existing UK permanent establishment (PE) engages in a transaction with a related company where the transaction or the related company lacks economic substance (as defined), and the transaction results in income to the related company that is subject to a lower tax rate; and/or
- avoidance of a UK taxable presence, section 86 – a non-UK company sells goods and services to consumers (who are located anywhere), supported by activity performed within the United Kingdom where the activity is designed to avoid a UK PE.

1.1. Interaction with the changes to the UK withholding tax rules

Following the changes to UK tax legislation introduced in Finance Act (FA) 2016, royalty payments and other similar payments made from one non-UK resident company to another non-UK resident company may be wholly or partly subject to UK income tax from 28 June 2016, where:

- the payments are for the use of, or the right to use, intellectual property (IP), as defined by section 907 of the Income Tax Act (ITA) 2007;
- the non-UK resident company making the payments has a UK PE; and
- the royalty payments are connected with a trade carried on by the payer wholly or partly through the UK PE.

At the same time, the rules for the computation of DPT profits were amended to ensure that, under the DPT rules, a company with an avoided UK PE is not better off than a company with a real UK PE. Accordingly, where a non-UK resident company is found to have an avoided UK PE, the notional PE profit calculation must include an amount equal to the total royalties paid by the non-UK resident company that would be subject to withholding under section 906 of ITA 2007 if the avoided UK PE were a real UK PE.

This can be illustrated using the following example. Imagine a case where there is a non-UK company recognizing sales and a UK company with associated sales and marketing activities. This non-UK company pays a

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1. HM Revenue & Customs Diverted Profits Tax Guidance (30 Nov. 2015), at 3.

2. These rules are included within UK Finance Act 2015, Part 3.
royalty to a non-UK IP owner in connection with those UK activities.

- In 2015, the DPT analysis was carried out and it was concluded that there was an avoided PE. For the purposes of the DPT rules in 2015, an appropriate calculation was done to identify the amount of profit that should be allocated to the avoided PE and the transfer pricing arrangements were amended such that the ongoing intergroup arrangements better reflect the reward for the UK activities.

- In 2016, as a result of the changes to the withholding tax (WHT) and DPT rules, there could be an increased level of diverted profits to the extent that there is still an avoided PE. For 2016, the notional PE profits associated with the avoided PE now need to be increased by the amount of the non-UK royalty to the extent that the royalty is connected with the activities of the avoided PE and apportioned on a “just and reasonable” basis.

Consideration should be given to what is a “just and reasonable” amount in these circumstances but, in many cases, it is difficult to see how a transfer pricing adjustment could be made for the connected royalty payment. Therefore, the result would be that an amount of the non-UK royalty is now subject to the DPT at 25% (as opposed to UK WHT at 20% for real UK PEs).

It is worth noting that it may be possible to obtain a credit to reduce the ultimate DPT liability where treaty relief would have been available in the case of a real PE, but if the IP owner is located in a non-treaty country, no such relief would be available.

In the example above, if the value driver of the business is IP, the non-UK royalty payment can be substantial, such that even a small attribution to an avoided PE could result in significant amounts of tax for HMRC if HMRC is successful in applying rules to the facts and circumstances of specific multinational business models.

2. DPT Notification and Qualifying Conditions

The notification provisions contained within FA 2015 are complex and require detailed consideration. Broadly, however, if a transaction or arrangement is assessed as being subject to the DPT, the taxpayer is under an obligation to notify HMRC within three months after the end of the accounting period to which the DPT relates.

The DPT rules need to be applied annually, so taxpayers should regularly assess whether they are potentially within the scope of the DPT legislation. Failure to notify by the statutory deadline can result in significant tax-garred penalties, in line with similar rules that apply to corporation tax.

Following notification, HMRC has a two-year window from the end of the relevant accounting period to issue a preliminary DPT notice. If there is no notification, this window is extended to four years from the end of the relevant accounting period.

2.1. Arrangements or entities lacking economic substance: The FA section 80 conditions

If all the conditions in section 80(1) of FA 2015 are met, the DPT rules apply and the amount (if any) of “diverted profits” should be calculated. Section 80(1) of the legislation provides that section 80 applies in relation to a company (C) for an accounting period if:

- C is UK resident in that period;
- provision has been made or imposed between C (the UK company) and P (another person) (whether or not P is UK resident) by means of a transaction or series of transactions (“the material provision”);
- the participation condition is met in relation to C (the UK company) and P (another person) (section 106);
- the material provision results in an effective tax mismatch outcome for the accounting period, as between C (the UK company) and P (another person) (section 107 and section 108);
- the effective tax mismatch outcome is not an excepted loan relationship outcome (section 109);
- the insufficient economic substance condition is met (section 110); and
- the UK company and the other person are not small or medium-sized enterprises (SMEs).

To the extent that all these conditions are met, a company will fall under the DPT regime and will then be required to calculate the amount of diverted profits. However, some of the conditions above are easier to determine than others. The ones that usually require further detailed analysis are the following:

- Section 80(1)(b): The definition of “the provision” and transaction or series of transactions has an effect on the analysis of subsections (d) and (f). Defining what the series of transactions are and the entities involved can be difficult to ascertain in multinational businesses with a complex value chain.

- Section 80(1)(d): The effective tax mismatch outcome (the ETMO) is a comparison of the tax rate of the foreign company with that of the United Kingdom. This is not just comparing the headline corporate tax rates of two jurisdictions, it is the tax rate in respect of the material provision, so preferential regimes need to be taken into account, such as the patent box or any rulings. In addition, if the foreign company is loss making, an analysis will need to be carried out as to whether the losses should be taken into account.

- Section 80(1)(f): The insufficient economic substance condition (the IESC) is that the transaction or series of transactions were designed to secure a tax reduction. In addition, there are broadly two exceptions to this rule that can be difficult to quantify and agree with HMRC. The first is if the first party and second party are taken together and taking account of all the accounting periods for which the transaction was to have effect, the non-tax benefits referable to the transactions would exceed the financial benefit of the tax reduction. Quantifying the financial benefit is relatively straightforward (subject to the difficulties
of the ETMO outlined above) as it will be the difference in the United Kingdom's and the foreign company's tax rate (in respect of the material provision) multiplied by the value of the transaction (whether as expense or reduction of income). Agreeing on what and how to calculate non-tax benefits can be very difficult as the legislation defines non-tax benefits as any financial benefit other than the tax reduction. The second exception analyses the contribution of the staff to the relevant transaction, which can be equally difficult to quantify.

2.2. Avoidance of UK permanent establishment: The FA section 86 conditions

If all the conditions in section 86(1) of the FA 2016 are met, the DPT rules apply and the amount (if any) of diverted profits should be calculated. Section 86(1) of the legislation provides that section 86 applies in relation to a company ("the foreign company") for an accounting period if:

(a) the company is not UK resident in that period;
(b) it carries on a trade during that period (or part of it);
(c) a person ("the avoided PE"), whether or not UK resident, is carrying on activity in the United Kingdom in that period in connection with supplies of services, goods or other property made by the foreign company in the course of that trade;
(d) 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 United Kingdom for the purposes of corporation tax (whether or not it is also designed to secure any commercial or other objective);
(e) the mismatch condition or the tax avoidance condition is met or both these conditions are met;
(f) the avoided PE is not excepted by activities not constituting a PE and/or the independent agent exemption; and
(g) the avoided PE and the foreign company are both not SMEs for that period.

As for section 80 cases, if all the above conditions are met, there will be an avoided PE and the next step is to calculate the amount of diverted profits. However, some of the conditions above are easier to determine than others. From a practical perspective, perhaps the most challenging area to reach agreement on has been whether the design test has been met or not:

- Section 86(1)(e): "Design test" – proving a negative is difficult, i.e. that there was no design, especially when the UK activities were established many years ago, such that there are limited contemporaneous records to review. In practice, where companies assert that there was no element of design of the UK activities, understandably, HMRC has asked companies to provide evidence to support such assertions.

Detailed information requests, e-mail and keyword searches as well as employee interviews have all been requested by HMRC in order to better understand whether there is evidence to suggest that the UK activities represent "contrived arrangements to circumvent rules on permanent establishment and transfer pricing".

3. Calculation of the Diverted Profits and Amount to Be Included within a DPT Notice

Having worked through the various tests to conclude whether the DPT rules apply, the next set of rules to consider is how to calculate the amount of diverted profits in a section 80 or section 86 case.

3.1. Using the actual provision

The actual provision only applies to expenses and not where the level of UK income is under consideration. It can also only apply when the relevant alternative provision would have also resulted in allowable expenses for the relevant company of the same type and purpose (whether or not to the same person).

3.2. Using the relevant alternative provision (RAP)

The relevant alternative provision allows HMRC to recharacterize arrangements to those of which it would be "just and reasonable to assume" that they would have taken place, absent tax considerations. This includes non-UK tax as well as UK tax. In theory, there might be a wide range of possible RAPs which might be applicable to a particular business. In practice, agreeing the appropriate RAP with HMRC is likely to involve extensive discussion and evidence. After hypothesizing an alternative business model, it is then necessary to consider the hypothetical transfer pricing arrangements in order to determine the amount of the diverted profits.

Once the calculation of the diverted profits has been carried out, the next step is to work out what the amount of the actual charging notice should be. One of the more interesting adjustments is the inflated expenses rule, as described in section 3.3.

3.3. Inflated expenses rule

The inflated expenses rule can apply in cases where HMRC considers that there is an avoided PE (the section 86 route) and/or when there are transactions lacking economic substance (the section 80 route). It is a rule that automatically disallows 30% of the relevant expense that has given rise to the effective mismatch outcome. In some cases, it can produce an unrealistic amount in the DPT notice that HMRC must issue. HMRC can only reduce the amount in the notice once payment has been made and the review period begins.

This difficulty is best illustrated by a section 80 example, where there is a business model involving a UK company

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acting as a distributor, purchasing goods from a manufacturer resident in a low-tax jurisdiction.

The business of the multinational company is the production and sale of widgets. The manufacturing is carried out in a low-tax jurisdiction and the role of the UK company is to act as the distributor of the widgets, bearing limited commercial risk. The UK company does not have any manufacturing capabilities, therefore it must purchase the goods from someone else. The expense to purchase goods from the manufacturer (based in a low-tax jurisdiction) would give rise to an ETMO. If it is assumed that all the other conditions are met and HMRC intends to issue a preliminary notice, the amount of the diverted profit must be calculated taking into account this rule. Assuming that the UK company is remunerated on a return-on-sales basis of 3%, this results in a payment to the manufacturer of GBP 100 million a year for goods. If, for DPT purposes, HMRC believes that the return on sales should be 4%, the costs of goods sold would be GBP 96 million. This means that the actual provision would apply and therefore the diverted profits equate to the difference in the costs of goods sold expense i.e. GBP 100 million minus GBP 96 million = GBP 4 million. Applying the diverted profits tax rate of 25%, this would result in DPT payable of GBP 1 million.

However, in this situation, the inflated expenses rule would apply. This is a mechanical rule that has the effect of disallowing 30% of the relevant expense that has given rise to the ETMO when calculating the amount of the diverted profits for inclusion in a preliminary notice. Applying this to the above example, the legislation would disallow 30% of the costs-of-goods-sold amount of GBP 100 million, producing diverted profits of GBP 30 million, which would require the company to pay DPT of GBP 7.5 million. There is no recourse for HMRC to reduce this amount, therefore it becomes payable when the charging notice is issued. In practice, it is expected that during the 12 month review period, HMRC would issue an amending notice to reduce the DPT to the GBP 1 million (i.e. the 4% return on sales), which HMRC believes has actually been diverted, and repay the difference.

As demonstrated by the example above, this rule can have a profound effect and it should be taken into consideration when analysing the impact of receiving a DPT notice.

4. **What Is Clear So Far about the DPT Regime?**

To understand whether there is any DPT risk, HMRC tries to obtain a comprehensive understanding of the business model and the global value chain and in particular how the United Kingdom fits within this value chain. For HMRC to achieve this detailed level of knowledge, a large amount of information is usually required, which can take considerable time. Given the fixed deadline for HMRC to issue a preliminary notice of two or four years, the information gathering process can significantly eat into this time frame. With this in mind, the authors recommend being prepared early: a DPT enquiry is resource intensive and a very complex process. Being able to call on expertise and advice in this area is usually invaluable in helping navigate these challenges which are vital to reach resolution as quickly as possible.

For companies, the DPT conditions need to be tested annually, requiring updates for material changes, from a legislative standpoint (i.e. updated WHT rules and interaction with the new anti-hybrid rules) and operational changes to the business (e.g. movement of senior people to the United Kingdom). As mentioned earlier, trying to provide evidence to explain the purpose behind a transaction or arrangement can be difficult. For any future restructuring, the appropriate documentation should be kept to help with any future DPT (or other tax) enquiry by HMRC.

Overall, the DPT was introduced as an anti-avoidance measure and HMRC has estimated the total yield for 2016/17 to be GBP 281 million. This comprises GBP 138 million for the DPT itself and a further additional corporation tax of GBP 143 million arising from the desired behavioural change from multinational companies. In an environment in which there is ongoing scrutiny of the tax affairs of multinationals, DPT is likely to remain a key HMRC tool. Accordingly, it is seen as a priority area, such that significant resources have been pooled from a range of skill sets and experience and invested in the HMRC DPT Team. With this in mind, it is reasonable to assume there will be more DPT investigations in the near future, particularly during 2018 as HMRC gets to grips with the impact of the DPT-related WHT changes.

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