Diverted Profits Tax

The diverted profits tax is a new UK tax targeting profits considered to have been diverted from the UK, applicable from 1 April 2015. The new tax can apply if there are either transactions in the global supply chain involving low-tax entities lacking economic substance, or arrangements which have a main purpose of avoiding a UK corporation tax charge. The new tax has potentially significant implications for the global supply chains of affected multinational groups which transact with, from or through the UK, whether they are headquartered in the UK or overseas, including the very real prospect of double taxation.

What is the diverted profits tax (DPT)?

The DPT is an entirely new UK tax that will be chargeable on affected UK and foreign companies from 1 April 2015.

The DPT was first announced by George Osborne, the Chancellor of the Exchequer, in his Autumn Statement on 3 December 2014, and the draft legislation was published a week later. The Chancellor said that the new measure would target “multinationals that use artificial arrangements to divert profits overseas in order to avoid UK tax”. The legislation is on a fast-track and will be included in the short Finance Bill 2015 which will be enacted before Parliament is dissolved in anticipation of the general election on 7 May 2015.

The tax enables HM Revenue & Customs (HMRC) to re-characterise the supply chain of affected multinational groups and re-compute the profits that, in its view, it is just and reasonable to assume would have been earned in the UK and subject to UK corporation tax, had the supply chain not been designed to secure group tax efficiencies. The DPT will be charged at the rate of 25% on those diverted profits, a rate 5% higher than the UK corporation tax rate. A company must pay the tax before it can make substantive representations to HMRC or appeal against an assessment on the merits to the Tax Tribunal.

Who may be affected by this development?

The tax has been commonly referred to in the press as the “Google tax”, and it will have a significant impact on the digital economy. However, the DPT has much broader implications for multinationals in general, whether they are headquartered in the UK or overseas, and across a very broad range of sectors, including consumer goods, industrial and manufacturing, pharmaceuticals and life-sciences, insurance and reinsurance, traders in the energy and commodity markets, EPC contractors, drilling companies and oil and gas contractors, among many others.
When can the DPT apply?

The DPT is potentially applicable in a range of commercially driven arrangements which would be currently respected under current UK and international tax norms.

Multinationals will be potentially at risk in three circumstances:

1. **Overseas mismatches** - A foreign company sells goods or services to UK customers (with a turnover in excess of £10m), but the company does not have a taxable presence in the UK and it is therefore not subject to UK corporation tax. Other persons are carrying on activities in the UK in connection with those UK sales. The foreign company makes payments to another foreign company which both lacks economic substance and is subject to a low rate of tax.

2. **Tax avoidance** - A foreign company sells goods or services to UK customers (with a turnover in excess of £10m), but the company does not have a taxable presence in the UK and it is therefore not subject to UK corporation tax. However, persons are carrying on activities in the UK in connection with those UK sales and there is an arrangement in place which has a main purpose of avoiding a UK corporation tax charge.

3. **UK mismatches** - A UK company enters into transactions with a foreign affiliate which either increases its tax deductible expenses or decreases its taxable income. The affiliate lacks economic substance and is subject to a low rate of effective tax (less than 16%) on the profits that would otherwise have been earned by the UK company.

How is the tax computed?

In any of these circumstances, HMRC can seek to assess DPT on the profit which it considers has been diverted from the UK through the manner in which the supply chain has been structured, even though no UK corporation tax would otherwise be payable under current law.

Where there is an overseas mismatch or a UK mismatch, HMRC can seek to re-characterise the supply chain if it is reasonable to assume that the transactions would not have been made or imposed in the same way in the absence of the effective tax rate mismatch. Where there is tax avoidance, HMRC can assess DPT on the profits of the foreign company which would have been chargeable to UK corporation tax if it was deemed to have a taxable presence in the UK.

In the first two cases, the DPT will be charged on the foreign company, as it will be deemed to have a taxable presence in the UK. However, the tax can be assessed on the company’s representatives in the UK and recovered from any affiliates with assets in the UK. In the third case, HMRC will assess the DPT on the UK company in the first instance, but can also seek to recover any unpaid tax from its affiliates.

Potentially vulnerable supply chain transactions include...

In addition to the internet companies selling goods and services to customers in the UK, potentially vulnerable commercial supply chain structures include:

- **Sales and marketing support**, where a UK-based marketing team originates and negotiates sales but contracts are concluded overseas
• **Commissionaires and limited risk distribution**, where a UK company sells goods and/or supplies services to customers on behalf of an affiliate, but does not contractually bear significant risk and earns a limited return.

• **Management services**, where a UK company employs executives who play a key role in negotiating or evaluating deals with third parties, but the contract is actually entered into by a low-taxed affiliate which sub-contracts various aspects of the work to others who actually have the capability to perform the contract.

• **UK IP development**, where a UK company has sold its IP to an affiliate in a low tax jurisdiction, or where a UK company may be performing contract R&D services for the affiliate, or where sales and marketing activities relating to the IP are being performed in the UK.

• **Property sale and leaseback**, and any situations where UK real estate is owned by a foreign affiliate and leased to a UK affiliate.

• **Equipment or vessel leasing**, where a UK company leases equipment from an affiliate in a low-tax jurisdiction.

• **Captive insurance**, where a low-taxed affiliate provides insurance or reinsurance coverage for UK or other affiliates, where a UK company is providing significant management functions supporting the business, but not actually underwriting risk in the UK.

• **Procurement**, where an affiliate in a low-tax jurisdiction procures goods and services and re-sells them at a profit to a UK company.

The DPT is a game changer in international taxation and undermines many generally accepted norms, including the basis upon which jurisdictions have generally agreed to allocate taxing rights in cross-border transactions through double tax treaties. The DPT creates significant uncertainty and risk, and raises the prospect of unexpected double taxation and protracted controversy.

HM Treasury is conducting a fast-track consultation with businesses and advisers on the draft legislation. The consultation will close on 8 February.

**Who should I contact if I want to know more?**

If you would like to discuss the potential implications of this tax, please get in contact with your usual contacts at Baker & McKenzie, or any of the members of the London Tax Team listed here.