Diverted profits tax

Following publicity given to global companies structuring their operations to minimise their exposure to UK tax, the UK government has introduced a new tax called the Diverted Profits Tax (**DPT**). The rate of tax is 25%. This compares to corporation tax at 20% falling to 17% in 2020.

Targeted at what HRMC describes as “aggressive tax planning that erodes the UK tax base through diversion of profits”, the breadth of the legislation creates uncertainty over whether it could apply to seemingly benign arrangements to reduce tax.

In practice, much will depend on the general approach taken by HMRC. Until we have a better understanding of that, businesses will want to know the sort of arrangements that could be challenged and so consider alternatives.

When will it apply?

The DPT has two limbs – involvement of entities or transactions lacking economic substance and avoiding a UK taxable prescence.

1. **Involvement of entities or transactions that lack economic substance**
   This targets a company in the UK that makes payments or passes income to an affiliate in a jurisdiction where the effective tax rate is less than 80% of the UK rate and the tax saving outweighed the other benefits. This could potentially impact a UK company making payments to an affiliate in Ireland given that country’s tax rate of 12.5% or even a UK company making royalty payments to affiliates in France with its special tax regime for intellectual property.
2. **Avoidance of a UK taxable presence**
   This targets a non-UK company trading with UK customers and which has some activity in the UK but designed in a way to avoid creating an actual UK tax presence. The DPT charge is on the additional profits which would have been attributed to the company if there had been a UK presence. This could potentially impact almost all non-UK companies that do business in the UK. While they may have no actual UK tax presence, it would not normally be that difficult to point to some activity in the UK, eg marketing, support or research.

Exclusions

Small and medium-sized businesses are excluded as are loan transactions. The avoided UK tax presence limb does not apply if sales do not exceed GBP 10 million or UK expenses are less than GBP 1 million.

Examples of when DPT could apply:

Insurance examples

1. A multinational manufacturer of specialist high value plant in a number of European countries with a UK subsidiary has product insurance indemnity with a large insurer but places the €50m excess on its insurance policy with an intragroup insurer established in a low tax jurisdiction. The intragroup insurer employs three people and most of the underwriting and actuarial risk pricing is outsourced to a specialist insurance consultancy based in the USA. HMRC say there are likely to be very limited circumstances where the use of intragroup insurance/reinsurance by a non-insurance group would not be within the lack of economic substance limb of DPT.
2. A non-UK headed multinational insurance group offers bonds from an overseas subsidiary to investors in the UK. These bonds are sold to customers through a UK distribution agent. The offshore company employs a team of actuaries and underwriters who design the range of bonds but the investment management function has been subcontracted to third party managers. The UK distribution subsidiary introduces potential investors to the overseas company who issues the bond to the investors. Even if the UK Company charges an arm’s length rate for its services, HMRC say the avoided UK taxable presence limb of DPT would be likely to be in point. However, the fact that design and origination of the bond products is performed by the overseas company may well mean that no additional profit on which UK tax would have been payable can be attributed to the company.

Property example
A UK company sells a development property to an affiliate in a low tax jurisdiction that funds the cost by borrowing and then leases the property back to the UK company. The offshore affiliate would be liable to pay UK income tax on the rent payable under the lease. However, the offshore company could claim an interest deduction in respect of its financing costs which could reduce the actual tax charge to zero. HMRC say that this could be within the lack of economic substance limb of DPT.

Companies must notify HMRC if they potentially fall within the scope of DPT and the notification requirement applies in a wider range of circumstances than the actual charge would apply to. The deadline for notification is three months after the end of the accounting period.

The Clyde & Co tax team is ready to advise on what companies should now be doing about this new tax. If you require further information, please contact Ray Smith (Tax Partner) or David Blumenthal (Legal Director).