Transfer Pricing Solutions Limited

UK Transfer Pricing Alert

UK goes nuclear on BEPS

Shortly before Christmas, the UK government announced the Diverted Profits Tax (DPT). This is a radical and far-reaching new approach to combat what it perceives as unacceptable (though legal) tax planning in relation to transfer pricing and PEs.

It purposely subverts and effectively overturns some of what have been the norms of international tax for many decades. This potentially adversely affects any corporate group that makes significant sales to UK customers, or that has other significant UK activities where the transfer pricing directly or indirectly involves low tax countries. Such businesses should urgently review the impact.

A full discussion would require many pages, but at a very high level, the key points are:

Objective

Although DPT is described as a tax, it is perhaps better viewed as an elaborate penalty to discourage 'overenthusiastic' international tax planning. DPT is charged at 5% higher than the normal tax on corporate profits. It is not intended that businesses will pay DPT; it is designed to be so harsh that businesses will change how they conduct business in the UK, in order that DPT does not apply. The aim is that UK taxable profits are 'voluntarily' changed to a level that the UK government thinks is a fair reflection of the economic activity in the UK.

Wide scope

Although the declared target is Google and other multinationals using notoriously aggressive international tax planning, the draft legislation has been worded to leave no loopholes, which means it potentially (inadvertently?) affects arrangements that have been considered uncontroversial for decades.

Harsher than OECD BEPS plans

DPT certainly pre-empts the BEPS process and may well be much harsher than the solutions being worked on by the OECD.

Tight timing

DPT will apply from 1 April 2015 (even if not made law until later), so there is less than 3 months to analyse whether DPT applies and, if it does, to mitigate the effect.

Inevitability

There are many good reasons why, in a sane world, DPT ought to be considerably narrowed and its introduction postponed pending proper consultation. However, there are lots of political reasons why the UK government almost certainly will refuse to do either.

DTAs might not apply

The UK government has made DPT a new tax, different from the normal tax on corporate profits, with the apparent intention that this means it is effective despite double tax treaties and EU freedoms. They may be wrong, but it may take years to find out for sure. If they are right, it may mean that no double tax credit can be claimed for DPT under the DTA.

Situations that are caught

The draft legislation is extremely complex and often ambiguous, so this short, paraphrased summary cannot capture everything. Heavily simplified, DPT can be seen as applying to two areas where the current OECD rules are seen as being inappropriately exploited:

1. Avoidance of UK PE

This leg of the rules can be seen as aiming to penalize perceived unfair exploitation of the PE exemptions.

DPT applies if a non-resident company, A, is making sales to UK customers (in excess of £10 million per year, including sales by related parties), with assistance from another person, B.

Certain conditions must be met, the key ones being that "it is reasonable to assume that":

(a) the activities of A or B are "designed so as to ensure that" A has no PE. An example would be where B's assistance in making the sale stops short of concluding the sales contract, so there is no PE.

(b) arrangements are in place in connection with the relevant supplies of goods or services, "one of the main purposes of which is to avoid" having a UK PE.

DPT is charged on the profits that it is "just and reasonable to assume" would have been taxable in the UK had the activities not been so designed. It doesn't mean there *is* a PE; it means the company is taxed *as if it had* a PE.

2. Transfer pricing that should be recharacterised, but can't be

The draft legislation does not mention recharacterisation, but the second leg of DPT is perhaps most easily understood as being intended to penalize perceived unfair exploitation of the fact that the OECD Transfer Pricing Guidelines allow recharacterisation of transactions only in narrow circumstances.

The conditions for this leg mean that it applies where companies that pay UK tax are involved in transfer pricing that also involves low-tax-rate entities that have low economic substance, such as certain IP holding companies or certain supply chain hub companies.

To be more specific, DPT applies if a company, C, has transactions (including a series of transactions) with another related person, P, whether UK resident or not, and the following conditions are met:

(a) As a result of the transfer pricing of those transactions, profits that would otherwise have been made by C are instead taxed in the hands of P at an effective rate that is lower than 80% of the rate that C would have paid, and it is "reasonable to assume" the transaction/s were "designed to secure the tax reduction". The 80% cut off would normally mean a rate of less than 16%, so would include Irish and many Swiss companies.

(b) P has insufficient economic substance, which is defined to mean that the value of the tax saving exceeds either:

> (i) the other financial benefits of the transaction/s for C and P combined, or
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> (ii) the economic value of the contribution to the transaction/s from the functions or activities performed by P's staff and independent contractors.

C could be a UK resident company or a UK PE of a foreign company or a notional UK PE (see 1. above).

DPT doesn't actually recharacterise the transfer pricing, because if that could be done under the OECD Guidelines DPT would not be needed. Rather, it charges DPT based on the hypothetical increase in profits that C would have made if the transfer pricing arrangements had instead been those that it is "just and reasonable to assume" would have been made in the absence of the tax saving.

Exemptions

There is an exemption from DPT based on size. To meet it, the company, combined with all related parties, must have fewer than 250 employees and either have turnover of EUR 50 million or less or assets of EUR 43 million or less.

Pure loan transactions are not caught.

Reporting

Companies are required to notify HMRC if it is reasonable to assume that DPT might apply to them. The process is that HMRC makes a quick preliminary judgement about whether to levy DPT. The company must then pay, based on estimation rules that are likely to overestimate DPT. No postponement is possible. HMRC then has a year to levy a final assessment, following which the company may appeal.