# UK Government Publishes New Diverted Profits Tax on Multinationals

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A surprise announcement by the UK Government last week was the proposed introduction of a new 25% profits tax – dubbed the "Google tax" – to counter the use of certain tax planning techniques by multinationals. The Diverted Profits Tax (**DPT**) will apply to taxable diverted profits arising from April 1, 2015.

Draft legislation and HM Revenue & Customs (**HMRC**) guidance on the measures have now been published and the Government has invited comments on it over the coming weeks. The draft legislation is lengthy and detailed. This note gives a brief overview of the basic structure of the DPT and offers a few insights on its more unusual and controversial features.

## Overview of the DPT

The DPT is presented as an entirely new tax. It is chargeable, very broadly, in two scenarios:

- where a non-UK resident company has designed its activities to avoid creating a taxable permanent establishment (**PE**) in the UK; and
- where a company which has a UK taxable presence creates a tax advantage by engaging in transactions that lack economic substance.

The Government has made clear that the much-publicized "double Irish" and "Dutch sandwich" structures implemented by some multinationals, and variations on those themes, are a direct target of the new rules.

Broadly, arrangements relating purely to financing are outside the scope of the DPT. There are also exclusions for small and medium sized enterprises and for sales activity beneath a *de minimis* threshold.

### Non-UK companies avoiding a UK taxable presence

This limb seeks to impose UK tax on companies that make substantial sales in the UK while falling short of creating a PE that is subject to UK corporation tax on the profits from those sales. A non-UK resident company will be subject to this rule if:

- another person is carrying on activity in the UK in connection with supplies of goods and services made by the non-UK company to UK customers;
- it is reasonable to assume that the activity of the parties is designed to ensure that the non-UK company does not have a UK PE (regardless of whether it was also designed with commercial or other objectives in view); and
- it is reasonable to assume that the "tax avoidance condition" or the "mismatch condition" is met.

The "tax avoidance condition" will apply where the arrangements have a main purpose of avoiding the imposition of UK corporation tax. This is targeting structures whereby the bulk of selling activity is done in the UK, save for the formal conclusion of the sale contract by an offshore group company.

The alternative "mismatch condition" is designed to bring income (e.g. royalty income) into the UK tax net, notwithstanding that the income has been paid away to another entity (e.g. to a related company in a tax haven, perhaps through a conduit company), but only in circumstances where there is: (i) a sufficiently significant net tax benefit underlying the arrangement (an "effective tax mismatch outcome"); and (ii) the

net tax benefit outweighs *either* the non-tax financial benefit *or* the value of the functions/activities of the recipient/conduit company's personnel (the "insufficient economic substance" test).

The proposed changes include an exception for investment managers, who are currently able to structure their arrangements to manage exposure to UK corporation tax. These arrangements should not be subject to the DPT. Accordingly, the changes should not cut across the UK's (well known) investment manager exemption.

### UK companies obtaining tax advantages

The second limb is focused on UK resident companies (or UK branches of non-UK resident companies) which enter transactions with related persons which – as per the "mismatch condition" above – result in an "effective tax mismatch outcome" and meet the "insufficient economic substance" test.

Rather than arrangements that aim to prevent a UK taxable presence arising, this rule is targeted at tax-motivated transactions that are erosive of the UK tax base. To judge from the examples given in the HMRC guidance, a particular focus here is on IP/royalty arrangements (again, involving conduit and tax haven companies).

## Practical Implications

The DPT proposals are a radical departure from the previously well-settled territorial basis on which the UK taxes corporate profits. While the policy behind the changes was likely formed with structures adopted by US multinational technology companies in mind, the rules will potentially have an impact on a far broader range of industries and taxpayers. Importantly, there are no grandfathering rules, so current intra-group arrangements will have to be reconsidered in light of the changes.

The provisions governing the computation of the DPT give remarkably broad discretion to HMRC to re-characterize the transactions in order to arrive at a "just and reasonable" assessment of diverted UK profits. Not only does this involve HMRC treating the non-UK resident company as if it actually had a UK PE, but HMRC may then also attribute profits to that PE on the basis of the (entirely hypothetical) alternative arrangements which would reasonably be expected to have taken place absent the tax planning. The uncertainty here could easily lead to protracted disputes between taxpayers and HMRC.

Another significant aspect of the rules is that they involve an element of self-assessment: taxpayers are required to notify HMRC if they think they might be within the charge (or risk a tax-geared penalty for non-compliance). Given the complexity of the charging provisions above, this is unlikely to be a straightforward exercise.

Finally, it is worth noting that it is unclear at this stage whether the DPT will be compatible with the UK's international obligations, both under double tax treaties and European Union law. Nor does the UK's unilateral action sit comfortably with its professed commitment to the OECD's BEPS Project, which emphasizes a co-ordinated, multilateral approach to developing international tax policy and which is due to report next year. A spate of new, un-harmonized anti-diversionary taxes in other jurisdictions – Australia has reportedly expressed interest in bringing in its own "Google tax" in light of the UK's announcement – would be an unwelcome development for multinational companies.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.


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