HIGH-SPEED TAX REFORM: THE U.K. DIVERTED PROFITS TAX & RESTRICTIONS ON CORPORATE INTEREST DEDUCTIONS

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INTRODUCTION

Over the past 24 months, the U.K. has seen significant changes to its corporate tax system. Two of the most notable changes concern the introduction of the new diverted profits tax ("D.P.T.") and restrictions to the U.K.'s previously generous tax relief for corporate interest payments.

The speed at which the U.K. has introduced these wide-sweeping changes is unprecedented – D.P.T. was first announced in November 2014 and came into force on April 1, 2015 – and is driven by the U.K. government's desire to combat unacceptable tax avoidance. This desire has been influenced by political pressure within the U.K. and from the international community.

The international focus on preventing corporate tax avoidance has been seen most notably through the O.E.C.D.'s Base Erosion and Profit Shifting Project (the "B.E.P.S. Project"). The B.E.P.S. Project aims to combat the artificial shifting of profits within a multinational group from high-tax jurisdictions to low-tax jurisdictions and the exploitation of mismatches between different tax systems that result in little or no tax being paid on a global basis.

Following international recognition that the global tax system requires a complete overhaul in order to prevent B.E.P.S., the G-20 asked the O.E.C.D. to recommend possible solutions. In July 2013, the O.E.C.D. published an action plan proposing 15 actions designed to combat B.E.P.S. at an international level, which included recommendations to restrict tax relief on corporate interest payments.

This article briefly considers both D.P.T. and the new restrictions on U.K. tax relief for corporate interest payments.

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DIVERTED PROFITS TAX

D.P.T. is a U.K. tax aimed at multinationals operating in the U.K. that artificially syphon profits out of the U.K. or try to avoid maintaining a taxable establishment by playing the complexities of the global tax system. It is primarily an anti-avoidance measure and was introduced in the Finance Act 2015.

It will be of particular interest to non-U.K. taxpayers because the usual double tax treaty relief provisions, which one would expect to override D.P.T. and take taxpayers outside the charge, do not apply. The U.K.'s revenue service, HM Revenue & Customs ("H.M.R.C."), takes the view that since D.P.T. is not income tax or corporation tax, it does not fall within the ambit of any of the U.K.'s current treaties. Some U.K. advisers to multinational groups expect that as individual treaties are updated, treaty partner jurisdictions will insist that the U.K. extend treaty protection

to D.P.T. Others are more skeptical, believing that the B.E.P.S. Project changed the expectations regarding the purpose of an income tax treaty. Preventing double non-taxation is now as important as preventing double taxation. In any event, treaty renegotiation is a process that will take years to come to fruition. Consequently, the intention of H.M.R.C. is that multinationals that do not have a U.K. permanent establishment ("P.E.") under a treaty are subject to U.K. tax as a measure to prevent unacceptable tax planning.

The current rate of D.P.T. is 25% of the diverted profit. D.P.T. is charged at a rate of 55% on ring-fenced diverted profits and ring-fenced notional profits in the oil sector. Given that the rate of U.K. corporation tax is currently 19% (and set to be reduced further to 17% from April 1, 2020), it is expected that companies affected by D.P.T. will seek to restructure operations so as to derive profits in the U.K.

When Does D.P.T. Apply?

D.P.T. applies to diverted profits arising on or after April 1, 2015. Apportionment rules are provided for accounting periods that straddle that date.

Broadly, D.P.T. applies in two circumstances:

- A group has a U.K. subsidiary or P.E. and there are arrangements between connected parties that "lack economic substance" in order to exploit tax mismatches. (One example of this would be if profits are taken out of a U.K. subsidiary by way of a large tax-deductible payment to an associated entity that is located in a tax haven and lacks the capability to perform an actual function that justifies the payment.)
- A non-U.K. trading company carries on activity in the U.K. in connection with supplies of goods, services, or other property. The activity is designed to ensure that the non-U.K. company does not create a P.E. in the U.K. and either (i) the main purpose of the arrangement is to avoid U.K. tax or (ii) a tax mismatch is secured such that the total profit derived from U.K. activities is significantly reduced. (This is referred to as the "avoidance of a U.K. taxable presence.")

Generally, in practice, D.P.T. should not apply to small- and medium-sized companies ("S.M.E.'s"). If a company has less than 250 employees and either its turnover is no more than €50 million or its assets are no more than €43 million, it should qualify as an S.M.E. However, when calculating whether a company is an S.M.E., it may be necessary to aggregate the number of employees and turnover/assets of certain linked companies.

Companies or P.E.'s Lacking Economic Substance

Where companies or P.E.'s lack economic substance, there are two tests that must be considered:

- The insufficient economic substance condition
- The effective tax mismatch condition

If either test is met, a D.P.T. charge will be payable.

“Where a transaction has been designed to ensure the avoidance of a U.K. taxable presence, a D.P.T. charge may arise.”

The insufficient economic substance condition will apply where (i) the tax benefit of the transaction is greater than any other financial benefit and (ii) it is reasonable to assume that the transactions were designed to secure the tax reduction.

Alternatively, it will apply where (i) a person is a party to one or more of the transactions, (ii) the contribution of economic value by that person is less than the tax benefit, and (iii) it is reasonable to assume that the person’s involvement was designed to secure the tax reduction. Broadly, this condition will not be met if there are real people engaged in activities that perform a real function that justifies the financial benefit.

There will be an effective tax mismatch if the transaction gives rise to a tax reduction for one party and the tax payable by the other party is less than 80% of the tax reduction obtained by the first party. There is an exemption for tax reductions arising solely from payments to registered pension schemes, charities, and persons with sovereign immunity, and payments to certain offshore funds or authorized investment funds.

Avoidance of a U.K. Taxable Presence

Broadly, where a transaction has been designed to ensure the avoidance of a U.K. taxable presence, a D.P.T. charge may arise where either (i) both the insufficient economic substance condition and the effective tax mismatch condition are satisfied or (ii) the tax avoidance condition is satisfied.

The tax avoidance condition will apply if arrangements are in place in connection with supplies of goods or services in the U.K. and the main purpose, or one of the main purposes, of the structure is the avoidance or reduction of a U.K. corporation tax charge.

Avoidance of a U.K. taxable presence does not exist if the U.K. activity is undertaken by someone acting as an agent of independent status or for the purposes of alternative finance arrangements.

There are also specific exceptions from a D.P.T. charge if, in a 12-month accounting period, U.K.-related sales are below £10 million or U.K.-related expenses are below £1 million.

Calculation of the D.P.T. Charge

Calculating the D.P.T. charge is complex, and various rules must be considered. Broadly, it will be necessary to consider profits that would have arisen if the company had made a full transfer pricing adjustment. It will also be necessary to determine the amount of profit that would have arisen from an alternative transaction that would have reasonably taken place if a tax reduction had not been relevant to the parties.

H.M.R.C. has stated that no taxable diverted profits should arise if, in the relevant transactions, the company made transfer pricing adjustments that put it in the same tax position as if arm’s length pricing had been used.

The main difficulty when calculating D.P.T. is likely to be the assumption that it is relatively easy to determine an appropriate alternative transaction that would have reasonably taken place if a tax reduction had not been relevant.

What Happens if D.P.T. Applies?

Notification

D.P.T. has its own specific rules for assessment and payment. D.P.T. is not self-assessed; rather, companies must notify H.M.R.C. if they are potentially within the scope of D.P.T. and do not satisfy any of the exemptions. Usually, this notification must be given within three months after the end of the company's accounting period.

Preliminary Notice

Following notification, if H.M.R.C. believes that a company may be liable for D.P.T., it will issue a preliminary notice to the U.K. company or P.E. This notice must outline the grounds on which H.M.R.C considers D.P.T. to be payable and calculate D.P.T. based on certain simplified assumptions. H.M.R.C. is also entitled to disallow up to 30% of the relevant tax-deductible expenses of the company, where it finds that these expenses are higher than they would have been if the transaction had been carried out on arm's length terms.

H.M.R.C. must issue a preliminary notice within two years of the end of the accounting period in which the D.P.T. charge arose. A company or P.E. has 30 days to contact H.M.R.C. to correct obvious errors in the notice, which might include arithmetical errors or errors regarding the company's status as an S.M.E. However, there is no right to appeal the preliminary notice.

The test for whether a D.P.T. charge applies relies heavily on questions of fact. Therefore, it is vital that taxpayers engage with H.M.R.C in the period after making a notification of potential chargeability, during which H.M.R.C will consider whether to issue a preliminary notice.

Charging Notice

Within 30 days of receiving any representations, H.M.R.C must either issue a charging notice stating the amount of D.P.T. payable by the U.K. company or P.E., or notify the recipient that no D.P.T. is payable. The recipient then has 30 days from receipt of the charging notice to pay any D.P.T. due. There is no right to appeal the preliminary notice or charging notice prior to payment, and there are no grounds for delaying payment.

Appeals

Following payment, H.M.R.C. has 12 months to review the charge to D.P.T. During this time, the charge may be reduced or increased. The company or P.E. can appeal a D.P.T. charge only after the 12-month review period has ended. An appeal is heard by the Tax Tribunal. If no appeal is made, the D.P.T. charge becomes final.

The fact that there is no right of appeal until 12 months after payment of any D.P.T. charge will mean that companies that are ultimately successful on appeal will suffer a significant cash flow disadvantage.

Clearances

There is no formal clearance procedure for D.P.T., although it may be possible to obtain a written opinion from H.M.R.C. on the likelihood a D.P.T. notice will be issued.

However, H.M.R.C. has cautioned that it will not be able to provide a view on whether transactions are likely to fall within the scope of D.P.T. in every case where an opinion is sought.

Expected Impact of D.P.T.

Although originally flagged to the market as a pure anti-avoidance measure that would be used only in exceptional cases of egregious tax planning, D.P.T. is expected to have a significant impact on multinationals and how they structure their businesses. In September 2016, H.M.R.C announced that it had identified almost 100 multinationals as being potentially within the scope of the new tax and was expecting many of them to dispute the charge.

Indeed, in November 2016, H.M.R.C. released figures showing that the amount of U.K. tax potentially underpaid by big businesses due to shifting profits to other jurisdictions has increased by 60% in the last year, to £3.8 billion.

This substantial increase suggests that H.M.R.C has opened a significant number of new inquiries over the last 24 months, focusing on intra-group, cross-border transactions. It has been suggested that D.P.T. could be one of the factors driving the increased amount of tax under consideration by H.M.R.C., and it is certainly the case that a threat of a D.P.T. charge is being used by H.M.R.C. as a weapon in transfer pricing disputes to force taxpayers to re-allocate taxable profit to the U.K.

It is clear that the scope of D.P.T. is wide and that extensive resources are being given to H.M.R.C to assess D.P.T. issues. Multinationals operating in the U.K. should expect H.M.R.C. to explore in depth whether a D.P.T. charging notice should be issued. Since the conditions for D.P.T. rely heavily on questions of fact, it is vital that companies engage in full fact finding and present evidence to H.M.R.C in as cogent a way as possible to support their arguments. It is also essential that companies have proper transfer pricing benchmarking measures both in place and appropriately evidenced, since this is a key way of avoiding a D.P.T. charge.

RESTRICTIONS TO CORPORATE INTEREST EXPENSE DEDUCTIONS

On April 1, 2017, the U.K. government introduced new rules restricting tax deductions for corporate interest payments. The draft legislation for inclusion in Finance Bill 2017 was published in full on March 20, 2017. However, following the U.K. prime minister’s decision to hold a general election on June 8, 2017, the draft provisions for the new rules were removed from the Finance Act 2017, which received royal assent (thereby becoming law) on April 27, 2017.

At the time of writing, it is uncertain whether the draft legislation will be enacted in a second finance bill this year and will still have effect from April 1, 2017. Depending on the outcome of the general election, it is possible that the draft legislation could be included as part of a second Finance Bill in summer 2017, or its enactment could be deferred further. Although such things are never certain, irrespective of the outcome of the general election, it is probable that the legislation will eventually be enacted in something like its current form, since it is rare for a measure so far advanced (and so lucrative for the U.K.’s Treasury) to be abandoned.

> ***"Under the new U.K. rules, tax relief for interest and certain other financing costs will be limited to 30% of tax-E.B.I.T.D.A."***

Previous U.K. Interest Deductibility Rules

Prior to April 1, 2017, the U.K. had generous rules in relation to tax relief on corporate interest payments. Generally, interest paid on debt financing was deductible from a company's U.K. corporation tax profits and therefore a company's liability to U.K. corporation tax was reduced.

In theory, interest payments could be used to reduce U.K. corporation tax payments. This form of tax relief was often invaluable, particularly to those corporations operating in the energy, real estate, and infrastructure sectors, which are heavily reliant on debt financing when embarking on new projects.

A range of anti-avoidance provisions existed to restrict excessive interest deductions, although there was no general limitation rule. Nevertheless, there was concern that the U.K.'s generous rules were open to abuse. For example, it was often cited that the U.K. interest deductibility rules enabled multinationals to load up U.K. companies with high levels of debt to reduce taxable profits, whilst shifting business profits to lower-tax jurisdictions that are tax havens.

However, given that the U.K. has extensive anti-avoidance rules to prevent such abuse, these concerns did not really carry any weight until the advent of the B.E.P.S. Project, which was the main driver for change.

Background to the New Rules – the B.E.P.S. Project

In July 2013, when the O.E.C.D. published its plan proposing 15 actions designed to combat B.E.P.S., Action 4 focused on limiting B.E.P.S. via interest deductions and, specifically, whether a general rule should be introduced to restrict the availability of tax relief on interest payments, regardless of the purpose of the debt or the party it is with.

In October 2015, the O.E.C.D. published its final recommendations in relation to Action 4. It recommended the introduction of a general interest limitation rule that should operate by restricting interest deductions by reference to a fixed ratio of a company's earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A."). The O.E.C.D. did not specify the level of this ratio; rather, it advocated that countries should choose an E.B.I.T.D.A. ratio of between 10% and 30%.

The O.E.C.D. recommended that there should be an optional exclusion for interest on loans used to fund public benefit projects. The rationale for this is that certain public benefit projects are considered to have a low tax avoidance risk.

The O.E.C.D. also recommended introducing several safeguards to address any potential volatility that the rule may create. These included a *de minimis* threshold for low risk entities and carry forward provisions, whereby disallowed interest deductions can be carried forward and deducted in a future accounting period.

The O.E.C.D. also suggested that jurisdictions should consider introducing suitable transitional rules, particularly to enable existing third-party debt to be excluded or "grandfathered" from the ambit of the new restrictions.

Overview of the New U.K. Rules

Under the new U.K. rules, tax relief for interest and certain other financing costs will be limited to 30% of tax-E.B.I.T.D.A., which will broadly be profits chargeable to

corporation tax, excluding interest, increased by (i) tax depreciation such as capital allowances, (ii) tax amortization and relief for losses brought forward or carried back, and (iii) group relief claimed or surrendered.

When applying the rule, groups will generally need to work out the tax-E.B.I.T.D.A. of each U.K.-resident member company and each U.K. P.E., and add them together. The limit on deductible interest will be 30% of that figure.

There will be a *de minimis* allowance of £2 million per annum, which means that groups with a net interest expense below this threshold will be unaffected by the fixed ratio rule.

A company will be able to carry-forward *indefinitely* interest expenses that have been restricted under the rule. The interest carried forward may then be treated as a deductible interest expense in a subsequent period if there is sufficient interest capacity in that period. Additionally, if a group has spare interest capacity for an accounting period it will be able to carry this forward and use it as additional interest capacity in subsequent periods, although it will expire after five years.

The new restrictions will apply to interest on existing loans as well as new loans, although limited grandfathering will be available in certain circumstances (see below).

Group Ratio Rule

The new rules will include a group ratio rule ("G.R.R."), based on the net interest to group E.B.I.T.D.A. ratio for the worldwide group, and will allow deductions up to the net interest to group E.B.I.T.D.A. ratio for the worldwide group if this exceeds the fixed ratio. This is intended to help groups with high external gearing for genuine commercial purposes, by substituting the G.R.R. for the fixed ratio rule if it produces a better result for the group.

The G.R.R. will be calculated by dividing the net *qualifying* group interest expense by the group E.B.I.T.D.A. When calculating the G.R.R., whilst net interest is essentially calculated in the same way as for the fixed ratio rule, the worldwide group-E.B.I.T.D.A. is an accounting measure – it broadly equals the consolidated profit before tax of the worldwide group, adjusted for depreciation and net interest.

The G.R.R. will be used as an alternative to the 30% fixed ratio rule. The amount of deductions available under the G.R.R. will be capped at 100% of tax-E.B.I.T.D.A.

Interest on related-party loans, perpetual loans, and result-dependent loans will not be included in the calculation of the G.R.R.

Earlier drafts of the legislation provided that a third-party loan guaranteed by a related party would constitute related-party debt, which would have resulted in many commercial loans being ineligible to be used as part of the G.R.R. However, following extensive lobbying from industry, the draft legislation has been revised and now provides that a loan will not be treated as having been made by related parties where (i) a guarantee is provided by a member of the debtor's group, (ii) financial assistance is only provided in relation to shares in the ultimate parent entity, or loans to a member of the group, or (iii) financial assistance is a non-financial guarantee. Limited grandfathering is also now available for guarantees provided prior to April 1, 2017.

Public Infrastructure Exemption

To maintain investment in the U.K.'s infrastructure sector, there will be an exclusion for interest paid on public infrastructure projects, known as the Public Infrastructure Exemption ("P.I.E."). Infrastructure projects tend to be highly geared, and their viability is often dependent on the availability of debt financing. Without a specific exclusion, many infrastructure projects would not get off the ground due to lack of affordable debt financing and difficulty raising equity finance.

The P.I.E. will only be available if an election is made and will only apply to companies where all, or significantly all, their income and assets relate to activities involving public infrastructure assets.

Meaning of Public Infrastructure Assets

For this purpose, public infrastructure assets will include the following assets:

- Tangible U.K. infrastructure assets that meet a "public benefit test"
- Buildings that are part of a U.K. property business and are let on a short-term basis to unrelated parties

The public infrastructure asset must also have, or be likely to have, an expected economic life of at least ten years and must be shown in a balance sheet of a member of the group that is fully taxed in the U.K.

An asset will meet the public benefit test if it is procured by a relevant public body (such as a government department, local authority, or health service body) or will be used in the course of an activity that is or could be regulated by an "infrastructure authority." This second leg of the definition should be wide enough to include projects relating to airports, ports, harbors, waste processing, energy, utilities, electric communications, telecoms, roads, and railways.

Companies will qualify for the exemption if they provide a public infrastructure asset or carry on activities that are ancillary to, or facilitate the provision of, a public infrastructure asset. The exemption will also apply to activities relating to the decommissioning of a public infrastructure asset.

Any building may be a "qualifying infrastructure asset" if it is part of a U.K. property business and intended to be let on a short-term basis to persons who are not related parties. "Short-term basis" means having an effective duration of less than 50 years and not being considered a structured finance arrangement. Buildings that are sublet are included in the definition.

Third-Party Debt Requirement

The P.I.E. will only apply to interest paid to third parties where the recourse of the creditor is limited to the income, assets, shares, or debt issued by a qualifying infrastructure company, which need not be the borrower.

Guarantees from parent companies or non-infrastructure companies within the group could prevent the exemption from applying. However, guarantees provided before April 1, 2017, and certain non-financial guarantees (relating to providing the services) will now be ignored.

Grandfathering Provisions

Originally, no grandfathering was proposed. However, there were significant concerns that grandfathering was required to prevent existing infrastructure projects from going into default, particularly those with shareholder debt, such as many existing P.F.I.-type projects, which may find it difficult to restructure. Examples include infrastructure projects involving U.K. schools and hospitals that are highly geared for genuine commercial reasons and where viability of a particular project is dependent on the tax deductibility of the project's interest expenses. These projects may have commenced ten years prior to enactment and may still have 20 or more years left to run – a restriction on tax relief could be catastrophic to the continued viability of such projects.

After much lobbying by industry, grandfathering was introduced for these projects. Although the new restrictions will apply to interest on existing loans, limited grandfathering will be available for infrastructure companies within the P.I.E. if the following conditions are satisfied:

- The loan relationships were entered into on or before May 12, 2016.
- At least 80% of the total value of the company's future qualifying infrastructure receipts for a period of at least ten years were highly predictable by reference to certain public contracts.

A transitional provision also applies in the first year to enable groups to restructure to fall within the P.I.E.

Administration of the New Rules

The new rules operate by assessing the level of interest in the worldwide group and therefore any restriction on the deductibility of interest cannot be processed through a company's normal U.K. corporation tax return. U.K. companies will now need to file a new interest restriction return.

The return contains basic information about the composition of the worldwide group, the key figures from the group interest level computation, and the allocations of any disallowances.

A short-form interest restriction return can be completed by companies claiming that the £2 million *de minimis* threshold applies. If a company elects to complete the short-form interest restriction return, it will not be able to use its interest allowance in a later period, although it will have 60 months to revoke its election and submit a full return.

Groups must appoint a reporting company to make the return. This is a company that is not dormant and was a U.K. group company or a group member subject to U.K. corporation tax for at least part of the relevant period to which the return relates.

Expected Impact of the New Interest Restriction

The exact impact of the new restrictions is not yet certain since the draft legislation, although far advanced, did not reach its final form at the time of the Finance Act 2017. However, multinationals can expect to undergo an extensive year-by-year compliance procedure to determine how much of the current U.K. interest deductions will become disallowable retroactively. A period of uncertainty will likely exist

during which corporate restructuring of U.K. sub-group debt-to-equity ratios may take place as if the new rules will be applicable.

SUMMARY

Both D.P.T. and the new restrictions on corporate interest deductions could have a significant impact on the structuring of U.K. corporate transactions involving significant levels of debt financing and entities located in multiple jurisdictions. Although both measures are predominately aimed at preventing aggressive forms of tax avoidance, they will unwittingly affect genuine commercial transactions. As with much U.K. tax legislation, both sets of rules are very complicated and can be difficult to navigate. Therefore, U.K. tax advice should always be sought before trying to apply the rules.

"Multinationals can expect to undergo an extensive year-by-year compliance procedure."

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