Taxation Committee

By email: divertedprofits.mailbox@hmrc.gsi.gov.uk

2 February 2015

Dear Sir/ Madam

Diverted Profits Tax: Draft Legislation

I am writing in my capacity as Chairman of The 100 Group Taxation Committee to take this opportunity to provide input on the draft legislation for the diverted profits tax that will be introduced from April this year.

Who we are

The 100 Group of Finance Directors represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent around 90% of the market capitalisation of the UK FTSE 100 Index, and in 2014 paid, or generated, taxes equivalent to 14% of total UK Government receipts. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the views of The 100 Group of Finance Directors as a whole, those views are not necessarily those of our individual members or their respective employers.

Our views

The 100 Group has been, and remains, supportive of efforts to address aggressive tax planning approaches that result in profits not being taxed in the appropriate jurisdictions. As such, we are supportive of the aims of the diverted profits tax. However, we believe that in the rush to enact this tax the proposed draft legislation is overly complicated and will capture transactions and arrangements that are not intended to be covered by this tax.

We would support re-drafting of this legislation to enable more efficient and effective implementation and enforcement, and to ensure that the tax has the desired effect. We urge you to re-consider the drafting to address two main concerns:

a) That legislation may catch arrangements that are not intended to be in scope; and
b) That the draft legislation may impose a disproportionate administrative burden on UK companies.

To assist you in your considerations we attach some examples and discussions of situations that we believe could be caught by the legislation as currently drafted, but which should not be within its scope. We are also aware that some member companies (either individually or through trade associations such as the ABI) have separately submitted examples.

<u>Clarifying the scope – which arrangements are covered</u>

As a matter of urgency we ask you to address the drafting of the legislation to set out the scope of this tax more clearly than in the current draft.

In particular, we recommend that the legislation includes a clear purpose statement that states unambiguously that the diverted profits tax is intended to capture tax on arrangements that are artificially constructed, abusive and that achieve a resulting tax advantage.

We also ask that you consider the drafting more generally to make it clear that legitimate commercial arrangements, such as those set out in the Appendix to this letter, are not covered by the legislation. This is vitally important to focussing the tax on the intended transactions and avoiding additional taxes on legitimate arrangements that alter the incentive structures of the UK tax system in unintended ways.

Greater clarity over which arrangements do, and do not, fall within the intended scope of the legislation will also reduce the burden on HMRC as the more specific the guidance then the fewer notifications of potential diverted profits situations would need to be assessed.

We recommend that part of the approach to clarifying the scope should be to address the Insufficient Economic Substance Condition. The first two of three tests in that condition consider whether the tax reduction is greater than "any other financial benefit". Financial benefit is not specifically defined in the legislation and we would welcome further examples in the guidance of what constitutes financial benefit.

<u>Addressing the administrative burden – a commercial 'gateway' and notification processes</u>

We recommend that you consider a 'commercial gateway' test to separate bona fide commercial arrangements from the artificial, aggressive structures that the tax should capture. It will be important for the efficient implementation of this tax that companies not employing such structures are not required to do the significant amount of work that the current draft of the legislation requires in identifying arrangements that may fall within the current scope, if the tax is not intended to include such arrangements. For example, a flow chart approach to guidance could effectively exclude genuine commercial transactions at an early stage of considerations.

We also have two specific suggestions of ways in which HMRC could also use information that they already have to lessen the compliance burden of the legislation. Firstly, where a business has been involved in advanced pricing arrangements ("APA") discussions with HMRC then a vast amount of information will have been shared on the covered transactions. This information will satisfy HMRC that the arrangements to which the APA applies are not contrived and that the UK is appropriately compensated for the specific UK functions and assets. We would welcome the addition of a specific clause in UK APAs signed after 1st April 2015 that confirm DPT has been considered and is not in point. Guidance on UK APAs should be updated to reflect this position.

We also recommend that to reduce the compliance and administrative burden, both for HMRC and for companies, that it is made clear in the guidance that re-disclosure of transactions is not required. I.e. where a business has already disclosed transactions/operations to HMRC as part of an ongoing open dialogue then guidance should confirm that there is no need to formally notify HMRC again within three months after the end of the accounting period.

In general, a clarification and simplification of the notification system should be a priority as you finalise the draft legislation.

We would particularly welcome a reduction in the initial assessment period which the draft legislation sets at 21 months for HMRC to issue a preliminary notice of chargeability (longer if no notifications made). A shorter period would increase certainty for business and would encourage businesses and HMRC to work together from an earlier stage to reach conclusions.

As a general point, we also encourage you to consider how this tax, and changes to UK taxation in general in the future, are coordinated with the OECD Base Erosion and Profit Shifting process, of which we have long been, and remain, strongly supportive.

We would be very happy to discuss this in more detail with you. Please do get in touch if you wish to discuss this further with me and the Committee.

Yours faithfully

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Chairman, Taxation Committee

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Appendix - Examples

We set out below some initial examples of situations that we believe could be caught by the legislation as currently drafted, but which should not be within its scope. We recommend that it is made very clear in the legislation that such structures are not caught.

1) Asset backed partnership structures

In some reasonably common asset backed pension structures a UK company transacts with another person (typically a Scottish Limited Partnership). Normally the UK company will pay rent to the partnership.

The UK company gets a deduction for the rental payment, but there is no tax in the partnership by virtue of the pension scheme partner's exempt status. The partnership would not normally have any employees.

It does not make any sense for this to be caught by the diverted profits tax as this is a commercial arrangement and is already subject to tax under the legislation specifically enacted to cover these structures.

2) Sale of trademarks outside of the UK

A UK company sells a trademark for *full market value* to an IP holding company in a low tax jurisdiction. The trademarks are licenced back to the UK.

This has clear commercial substance where the multinational enterprise holds the majority of its trademarks in that location, and has a team of professionals there who manage, protect and develop the commercial value of those trademarks.

3) Transfer of technology assets

A UK company transfers technology assets to an overseas subsidiary in exchange for shares. The UK company pays the overseas subsidiary for the use of the technology assets. The assets are amortised for tax purposes in the foreign subsidiary, so in practice it pays little tax for the first few years.

The subsidiary also holds assets which were developed in other countries and they are all brought together in order to achieve efficiency and to optimise their further development under a management team in that company.

4) Captive insurers

A UK company paid premiums to an insurance captive located in a lower tax jurisdiction that are not subject to a UK CFC charge. That captive may have few employees.

Many multinational enterprises have such captive insurance companies to insure risks in their group. Such arrangements can enhance the group's risk management processes and efficiency and have a bona fide commercial rationale.

Another related scenario is a UK company that paid premiums to an insurance captive located in a lower tax jurisdiction that is subject to a UK CFC charge, but in a different UK company. There is no UK tax creditable against the diverted profit tax charge. It seems that the provisions for crediting tax in the draft legislation do not appear to apply where the CFC charge is incurred by a different UK company.

5) Central UK employing entity and company with returns from capital investment

A UK entity A employs most of the staff in a UK group and makes service charges for the work performed by those staff to other UK group companies (which is then tax deductible in those companies). The principal company to which A makes service charges is another UK company, B, which owns and exploits intangibles as part of an active franchise and management business. Amongst multiple UK and foreign third party and related party agreements B has granted a licence to a further UK group company, C, which conducts third party management business. Company A also makes charges to company C.

The employment entity A earns UK taxable profits from its service charge income, but with those profits reduced by various UK reliefs and deductions. Those reliefs and deductions could be significant in some cases, for example when there are significant levels of capital allowances available after having disclaimed in previous years, and/or where there are deductions for pension contributions where spreading has applied.

Company B earns UK taxable profits which include profits from its charges to C. B's profits are reduced by various reliefs and deductions, including relief for IP amortisation and relief for expenses charged by company A. Company C's profit margin is small after deducting expenses payable to A and B.

In that case, the circumstances of C appear likely to fall within the scope of the numerical tests in the legislation – although it is not clear how those tests should be applied (e.g. how 'other financial benefits' are determined). It is conceivable that the same would apply with respect to any other group companies to whom A or B made charges (or to B itself). These concern purely UK domestic circumstances.

The existence of such central employment and service charge activity is commonplace, as is the existence of group companies making group charges attributable to use of capital assets rather than people functions. Each are normal and commercially reasonable approaches to effectively conducting business.

6) Irish interest free loan via the UK

An Irish company (CFC) provides an interest free loan (IFL) to a connected UK company, which makes an interest bearing loan to a connected non-UK company. The Irish company is not trading and so there is no transfer pricing adjustment for Irish tax purposes, and so no Irish tax is paid. There is a CFC charge on 25% of the interest income deemed to be received by the Irish CFC. The UK company obtains a corresponding adjustment and has a deemed interest expense.

The IFL may not qualify as an "excluded loan relationship" as the structure includes and equity contribution into the Irish company.