**Updates to HMRC Diverted Profits Tax Guidance**

**DPT1010 - Who is affected?**

The Finance Act 2016 introduced changes to the rules in respect of the deduction of income tax from payments of royalties. To ensure that these changes cause no advantages to accrue to a person within the charge to diverted profits tax, the calculation of profits diverted from the UK may also include, for accounting periods ending on or after 28 June 2016, an amount equal to payments of royalties and other sums in respect of intellectual property that would have been subject to the deduction of income tax at source had an avoided permanent establishment (PE) been an actual permanent establishment in the UK.

**DPT1132 – Consequences of section 80 or 81 applying: key definitions**

An example illustration of the relevant alternative provision is outlined in DPT1330.

**DPT1138 - Consequences of section 80 or 81 applying: section 85: calculation by reference to the relevant alternative provision: Example 1** - when calculating the taxable diverted profits, the sum was calculated less an amount in respect of expenses it would be just and reasonable to assume would have been incurred in holding the asset.

**DPT1139 - Estimating profits for notices – section 80 or 81 case** - The calculation of the diverted profits can be adjusted during the review period, on the basis of evidence received, by the issue of either a supplementary charging notice or an amending notice (DPT2180 / 2190). If so then the special rules for making estimated calculations are ignored when computing the amount of taxable diverted profits to be included in such a notice.

**DPT1140- Section 86 – avoidance of a UK taxable presence – Situation 3 (See DPT1310)**

For it to be reasonable to assume that activity is designed to ensure that the foreign company is not carrying on a trade through a UK PE there will be some degree of contrivance in the arrangements – present in the accounting period, irrespective of the accounting period in which that contrivance was designed. They will differ in some material way to the arrangements that we would expect to have been made if there had been no considerations around the PE threshold.

**DPT1162 - Consequences of section 86 applying: section 88: key definitions –**

The 'notional PE profits': This means:

- the profits which would have been the chargeable profits of the foreign company, attributable in accordance with sections 20 to 32 CTA 2009, had the avoided PE been an actual PE in the UK through which the foreign company carried on the trade; and
- for accounting periods ending on or after 28 June 2016, any amount equal to the total of royalties or other sums which are paid by the foreign company during that period in connection with that trade, in circumstances where the payment avoids the application of Section 906 of the Income Tax Act 2007 (duty to deduct tax).

"The actual provision condition" is met if the material provision results in expenses of the foreign company for which (ignoring Part 4 of TIOPA 2010) a deduction for allowable expenses would be allowable in computing what would have been the notional PE profits for the accounting period and the relevant alternative provision would also have resulted in the foreign company having expenses that would (ignoring any transfer pricing disallowance) be allowable in its tax computation and the relevant alternative provision:

- would also have resulted in allowable expenses of the relevant company of the same type and for the same purpose as the actual expenses, and

- Would not have resulted in "relevant taxable income" of a connected company.

**DPT1168 - Consequences of section 86 applying: section 91: mismatch condition is met: calculation by reference to the relevant alternative provision**

Section 91 applies where the mismatch condition is met but the actual provision condition is not met. That is, either the relevant alternative provision would not have resulted in expenses of the same type and for the same purpose or the actual provision condition would have applied but for the fact that the relevant alternative provision resulted in relevant taxable income.

**DPT1169 – Estimating profits for notices – section 86 cases**

If the activity carried on in the UK was selling products, or providing services, to customers of the foreign company it may be that the price paid to another group company for the products or services includes embedded royalties. If the arrangements around such royalties met the required conditions but those for the rest of the product or service price did not then it would be appropriate to apply the 30% adjustment only to that element of the expense.

For accounting periods ending on or after 28 June 2016, the notional profit also includes any amount equal to the total of royalties or other sums which are paid by the foreign company during that period in connection with that trade, where the payment avoids the application of Section 906 of the Income Tax Act 2007 (duty to deduct tax).

**DPT1181 – Effective tax mismatch outcome - reduction in the income of the first party**

In most cases it should be clear whether the material provision results in "expenses of the first party", but it may be more difficult to know whether it results in "a reduction in the income of the first party that would otherwise have been taken into account ..." Such a reduction in income may relate to an arrangement to net an expense against income, but also where income itself is diverted and the first party's income is reduced to less than it would receive under arm's length conditions.

A situation that could be in scope would be where a UK company transfers an asset with an established income stream to an affiliate in a low tax jurisdiction and that affiliate, because of its own lack of substance, relies on the UK company to manage the asset. The material provision is not just made by the transfer of the asset but also by the transaction under which the UK provides the functions needed to develop, enhance, maintain, protect and exploit the asset. This of course results in income to the UK Company, but less than either; what would have been the case if the asset had not been transferred, or if the transaction had been calculated in accordance with the arm's length principle.

**DPT1991 – The sufficient economic substance – detail**

The transaction based tests

An example illustration of potential non-tax financial benefits is outlines in Example 1 of DPT1390

**DPT1310 – section 86 - avoiding a UK taxable presence (see DPT1140) - Example 1: Company resident in very low tax jurisdiction in international supply chain - tax avoidance condition met**

Specific changes to clarify 'key commercial' terms for contracts agreed but signed in a different country.

**Analysis and calculations of taxable diverted profits**

Section 86 therefore applies and the taxable diverted profits are the profits which would have been the chargeable profits of the ESC for the period, attributable to the avoided PE, had the avoided PE been a permanent establishment through which the ESC carried on its trade in the UK - : notwithstanding, for accounting periods ending on or after 28 June 2016, consideration would need to be given to whether there are any amounts, where the payment avoids the application of Section 906 of the Income Tax Act 2007 (duty to deduct tax).

The amount chargeable to DPT charge will be equal to the notional PE profits. These are (i) the profits that would have been the chargeable profits of the foreign company, attributable in accordance with sections 20 to 32 of CTA 2009 had the avoided PE been a permanent establishment in the UK through which the foreign company carried on its trade and (ii) for accounting periods ending on or after 28 June 2016, any amount equal to the total of royalties or other sums which are paid by the foreign company during that period in connection with that trade, where the payment avoids the application of Section 906 of the Income Tax Act 2007 (duty to deduct tax).

In determining the amount of the notional PE profits, account would be taken of the fee which is paid to the UK sales support company for its services. As this fee confers 50% of the distribution profit, the profits to be attributed had the avoided PE been an actual PE of the ESC as principal would be 48% of the distribution profit. For accounting periods ending on or after 28 June 2016, there may also be an amount equal to the royalties or other sums which are paid by the foreign company during that period in connection with that trade, where the payment avoids the application of Section 906 of the Income Tax Act 2007. These two figures would determine the amount of the taxable diverted profits.

**Example 3: Avoiding a UK taxable presence (see DPT1140)**

In estimating the taxable diverted profits for the preliminary and charging notices the designated officer would need to consider what the chargeable profits of Company B would have been if it had been carrying on its trade through "the avoided PE". In considering the appropriate deduction for the IP expense, the inflated expenses condition would need to be considered. Finally, for accounting periods ending on or after 28 June 2016 the quantum of diverted profits will include any amount equal to the total of royalties or other sums which are paid by Company B during that period in connection with that trade, where the payment avoids the application of Section 906 of the Income Tax Act 2007 (duty to deduct tax).

The calculation of diverted profits tax, will be based on whatever position it is reasonable to assume would have been made had tax on income not been a consideration, Company B would have made some payment in respect of its use of the IP. In this case there is no reason to believe that such payments would have given rise to "relevant taxable income" in the UK. On that basis the calculation of taxable diverted profits would be on the basis of the actual provision and would be equal to the chargeable profits which Company B would have made if it had been carrying on its trade through the avoided PE – Company E (taking the proper pricing of the actual provision into account), together with, for accounting periods ending on or after 28 June 2016, any amount equal to the royalties or other sums which are paid by Company B in connection with that trade, where the payment avoids the application of Section 906 ITA 2007.

When estimating the diverted profits for the purpose of the preliminary and charging notices, if there is reason to consider that the actual expenses might be greater than they would have been if agreed between independent parties acting at arm's length then the amount that would otherwise have been allowed in the calculation would be reduce by 30%

Whether or not this adjustment to the IP expense is ultimately the correct transfer pricing adjustment is a matter to be considered during the review period. The ultimate level of taxable diverted profits should reflect what the chargeable profits of Company B would have been, (for accounting periods ending on or after 28 June 2016), anuy royalties or other sums pad by Company B during that period in connection with that trade, based on the assumptions mentioned above.

**DPT1360 Specific tangible asset examples - Example 1: Analysis**

Technically, an effective tax mismatch outcome can arise in the latter circumstance (i.e. where this is directly suffered by the landlord, and not by way of withholding tax), perhaps as a result of non-qualifying deductions being taken into account under Section 108(2)(b) FA15 e.g. interest expense incurred by the overseas company.

**DPT1390 Example 2: Intragroup insurance within a non-insurance group**

**Analysis**

This is not a regulated insurance group and the intragroup insurer is not being used to create capital efficiencies. The UK company has sufficient liquid assets to meet expected potential claims in excess of the cover.

The functions performed by the group insurer are minimal. Consequently, it is reasonable to assume that the non-tax benefits attributable to the functions of the group insurer will not exceed the financial benefit of the tax reduction arising from insurance transactions between it and the UK company. The premium paid by the UK company is correctly priced but there are no commercial motives for the transaction other than the tax saving. It follows that absent the tax mismatch the UK company would not have insured with the group insurer.

**DPT 1395 – Lloyd's: updated version**

The commencement provisions in section 116(4) Finance Act 2015 ensure that Lloyd's members are subject to DPT on profits declared in the 2015 calendar year and subsequent periods. The DPT only applies to profits referable to periods from 1 April 2015.

The 2013 year of account will include profits from 2013, 2014 and 2015. The DPT provisions do not apply to profits referable to times before 1 April 2015, that is, profits from 2013, 2014 and 1 January 2015 – 31 March 2015. Profits referable from 1 April 2015 are within scope of DPT.

DPT may apply to a year of account prior to 2013 if the year of account is in run off and there are profits referable to times on or after 1 April 2015.

Profits within the scope of DPT of a year of account are allocated to each period on a just and reasonable basis.

**Chapter 3 - Customer engagement with HMRC: DPT 1600 - Introduction**

In early 2018 the LB TF (the Large Business Task Force) merged with the LB Strategic Risk Unit to form the Large Business National Compliance (LB NC) group. LB National Compliance contains a Diverted Profits Team of around 40 experienced specialists. They are working with CCMs and tax specialists to look across all business sectors and consider whether businesses have used profit shifting structures which HMRC should challenge using transfer pricing, DPT or other legislation.

HMRC committed further resources in 2017 by creating additional national teams. These teams bring together the necessary investigative, technical and leadership skills from various Directorates to investigate arrangements to avoid UK tax by diverting profits involving businesses in both HMRC's Large Business and Mid-Sized populations which are outside the scope of the SME exemption.

**What businesses can expect from HMRC**

Our engagement with customers with regard to DPT will be in accordance with HMRC's Litigation and Settlement Strategy (LSS). This outlines the framework within which HMRC handles and resolves tax disputes through civil law processes and procedures in accordance with the law. It applies irrespective of whether the dispute is resolved by agreement with the customer or through litigation.

**HMRC's risk identification and assessment activities**

As with other areas of tax, HMRC uses data profiling and intelligence gathered from other sources across businesses in all sectors to identify customers with features which could indicate profit diversion.

HMRC will carry out an initial risk review of businesses it considers may fall within the scope of DPT. This will form part of a wider risk assessment of transfer pricing and other international risks and will use information already held by the department and public source information. It will also consider any information and analysis provided by the business as a result of real time engagement. HMRC will not usually request information at this stage. These initial risk reviews are considered by experienced specialists who make up the membership of a cross-directorate Diverted Profits Panel (DP Panel).

Where the DP Panel determines the business to be 'Low' risk of diverted profits and there is already discussion with the business about the applicability of DPT, HMRC may communicate to the business that no further engagement on DPT is currently planned.

If the DP Panel considers a business is high risk for DPT and decides to authorise opening an investigation, HMRC would then consider whether there are sufficient resources available to progress that investigation at pace to meet DPT deadlines. If not, HMRC would wait until the necessary resources required to investigate the arrangements become available. As in other areas of compliance work, HMRC 'resources to risk' whereby resources are allocated first to the greatest risks. Factors taken into consideration in prioritisation decisions include: the estimated scale of the risk; the behaviours involved; whether the issue is novel or one which could set a wider precedent; whether there is already a 'dispute' as defined in HMRC's Litigation and Settlement Strategy, and whether there are sufficient resources available to progress that investigation at pace to meet DPT deadlines.

**HMRC governance**

When the detailed risk assessment concludes that a preliminary notice should be considered this recommendation will be subject to governance. The LSS applies to all tax disputes resolved through civil procedures and to all decisions taken by HMRC in relation to such disputes. Decisions needed to give effect to the principles of the LSS in individual cases or for issues affecting a number of customers are taken within appropriate HMRC governance arrangements. Furthermore, where the case team wishes to recommend acceptance of a resolution proposal put forward by the customer this will be subject to governance by independent senior officers who are members of a cross-directorate board and potentially other governance boards. Further details on HMRC's governance procedures can be found at DPT2740.

**Changes to naming:**

- Customer Relationship Manager (CRM) changed Customer Compliance Manager (CCM)
- Diverted Profits Risk Team (DPRT) changed to Diverted Profits Tax Specialists (DPTS)
- Large Business Task Force (LB TF) changed to Large Business National Compliance (LB NC)

**DPT1610 – DPT – Internal advice &support network for case workers and CRMs**

- **Designated HMRC officer.** The designated HMRC officer has statutory responsibility under the DPT legislation for issuing preliminary notices, considering representations on the preliminary notice, issuing charging notices, estimating profits for preliminary and charging notices and carrying out the review of the charging notice, including any issue of supplementary charging notices or amending notices.

**DPT1640 - No formal statutory or non-statutory clearance procedure for DPT**

HMRC is committed to meeting its international exchange of information obligations. If HMRC provides an opinion on the application of DPT to customer arrangements this may constitute a "ruling" for international taxation purposes, meaning it is very likely to be required to be exchanged with another jurisdiction.

For more information, including whether, when, and how HMRC exchange or make a request from foreign fiscal authorities for such rulings: please consult IEIM500000+ onwards.

**DPT1670 - Seeking information from other sources**

HMRC's personal information charter sets out the standards you can expect from HMRC when we request or hold information about customers during their dealings with us.

**DPT1675 - Detailed risk reviews - Operational approach**

In the context of this guidance, an active process involving full co-operation and disclosure towards resolving the transfer pricing issues includes:

- complete transparency over the global arrangements;
- interaction with a realistic prospect of a successful conclusion within a reasonable time frame and not just a continuation of exchanges of views and/or the provision of information and documents from the customer; and
- genuine progression towards agreement on the appropriate quantum of the adjustment in order to settle the transfer pricing issues.

Where a business is not fully cooperating HMRC may consider a Preliminary Notice.

**Example of initial information request**

Additional example of Product lifecycle journeys which facilitate a detailed understanding of the involvement of all entities involved in relevant products from 'cradle to grave'. This may include areas such as:
(a) Research & development
(b) Key milestones
(c) Manufacture / distribution
(d) Marketing and commercialisation
(e) Regulatory requirements
(f) Sales process including pricing models
(g) Governance roles and processes including Boards, committees and panels together with those individuals that are members.

Running Investigations – Typical HMRC Approach
Many contrived arrangements to divert profits use legal structures to shift profits away from where economic value is being added. HMRC wishes to work collaboratively with businesses to understand the arrangements, and what is being done on the ground in the UK and overseas with reference to evidence.

The approach to any particular DP investigation is determined in the light of the level of risks and the nature of the issues being investigated and therefore should be determined on a case-by-case basis.

HMRC in running a DP investigation may consider carrying out the following practices where appropriate:

- Requesting and reviewing relevant transfer pricing documentation and intercompany agreements and seeking clarification from the customer on any areas that appear unclear;

- Holding a meeting with the customer at the outset – involving the CCM or DPTC, in a MSB case, appropriate senior managers and members of the tax team from HMRC and the customer – to outline the potential tax risks, agree a high level timetable for investigation, and the resources that would be required from both HMRC and the customer;

- Encouraging cooperation and agreeing with the customer a joint action plan for carrying out work - discussing regularly progress against the plan, the reasons for any potential slippage and keeping it updated;

- Establishing the facts before getting into detailed technical discussions. Ensuring that the key facts gathered as the investigation progresses are recorded and discussed with the customer. Any narrative provided by HMRC that summarises key facts is not intended to be agreed by the customer as a 'Statement of Facts' – it is HMRC's summary of the key facts. It should not include assertions, argument or conclusions drawn from the facts;

- Not considering just the UK economic activities in isolation but understanding them in the context of the global value chain – HMRC needs to understand the worldwide picture and the totality of the arrangements that are in place to reach a view on whether a DPT charge arises;

- Formulating informal information requests in a format which can be converted easily into a formal request, and having a dialogue with the business about the relevant information and evidence and how it can best be provided. Following that discussion HMRC expects the customer to respond thoroughly and timeously;

- Using information powers promptly, where necessary, to obtain the evidence HMRC considers relevant. Following up failures to comply with formal information notices and considering the application of relevant penalties;

- Promptly reviewing information and documents provided by the customer and then discussing the next steps with the customer;

- Holding regular face-to-face meetings to ensure that the customer and HMRC understand each other's technical analysis and arguments, the key facts on which they are based, and the key differences of view. Agreeing an agenda and where possible circulating papers in advance. HMRC and the customer should both ensure that the right people attend the meeting to discuss the agenda items;

- Considering when appropriate the issue of protective assessments, and Notices to File on overseas entities to protect permanent establishment challenges; and

- Considering recommending the issuance of a Preliminary Notice charging DPT. HMRC should explain its views and plans to the customer in this regard and give them the opportunity to respond before recommending the issuance of a Preliminary Notice through DP governance.

**DPT1680 – Notification**

Where there is no existing engagement with a business, HMRC will not, as a matter of course, respond to a DPT notification. Therefore, if a customer has notified potential liability to DPT but concluded that there is no DPT to pay and has not heard from HMRC, the customer cannot assume that HMRC agrees with their view that they are not within the scope of DPT.

**DPT2035 – Failure to notify penalties**

The measure of tax on which the penalty is based is the amount of DPT which would be charged had a notice been issued 6 months after the end of the review period and payable at that time.

The assumption in Para 7(4A) Sch 41 FA 2008 is that the DPT is required to be paid within six months of the end of the accounting period. Therefore six months after the end of the accounting period is the date when the DPT is treated as first becoming unpaid by reason of the failure to notify (FTN) as potentially within scope of DPT for the purposes of Sch 41 FA 2008. In non-deliberate FTN cases, this is the relevant date when considering whether HMRC has become aware of the failure within 12 months of the tax first becoming unpaid by reason of the failure to determine whether the greater penalty reduction applies.

In light of the timing of this guidance, where the FTN is not deliberate, and the DPT would be treated as first becoming unpaid by reason of the failure before 1 January 2019 it will be considered to have first become unpaid on 1 January 2019 and this date will apply for the purposes of Sch 41 FA 2008 in deciding whether HMRC became aware of the failure within 12 months of the tax first becoming unpaid by reason of the failure. Where the DPT first becomes unpaid by reason of the failure after 1 January 2019 the date 6 months after the end of the accounting period will be the date the DPT is treated as first becoming unpaid by reason of the failure for the purposes of Sch 41 FA 2008.

**DPT2038 – Interaction with CT penalties**

In cases where the case is ultimately concluded by a CT adjustment which replaces the DPT charge wholly or partially, it may be that the company is potentially liable to both a CT inaccuracy penalty and a DPT failure to notify penalty based on the same profits. In such cases HMRC will calculate the penalty liability based on the larger of the two penalties based on the potential lost revenue which arises from the overlapping profits.

**DPT2620 - Time limits within the DPT legislation**

Review period: Changed from 12 to 15 months beginning immediately after the latest day for payment of the DPT (the review can be for a shorter period if there is agreement by both sides or if the company notifies that it is terminating the review following a supplementary charging notice – DPT 2690).