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Client Alert

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# UK government proposes changes to transfer pricing, permanent establishment and diverted profits tax rules

An in-depth look

## In brief

The UK government has opened a consultation on a number of proposed changes to the transfer pricing, permanent establishment and diverted profits tax legislation.

The stated purpose of the reform is to clarify and modernise the legislation, and ensure it achieves its objectives, while developing simpler rules that are easier to understand and which support growth by improving tax certainty. Beyond simplification, the k ey theme running through the consultation is to achieve further alignment between UK domestic legislation and OECD international principles. HMRC has confirmed that the entirety of the package of reforms is intended to be revenue neutral.

The deadline for responses is 14 August. HMRC will also run four stakeholder events, covering different topics, at the end of June/ beginning of July. HMRC anticipate draft legislation may be announced at the next Autumn Statement or Spring Budget and has already indicated that there may not be sufficient time for a full consultation on it. This is far from id eal given that the proposed reforms affect several key areas of UK tax legislation.

There is much to digest in this latest HMRC consultation, which impacts on fundamental UK aspects of international tax planning for multinational groups. Our insights in this alert benefit from having attended the first of HMRC's consultation meetings at which we were able to learn more.

## Key takeaways

1. Transfer pricing (TP)

   The government's consultation on UK TP rules, among other things, touches on terminology that goes to the heart of the mechanics of the legislation and the risk is that if the proposed reforms are adopted, we could end up with an initial period of increased uncertainty which would need to be further refined in HMRC guidance.

   Other proposed changes concern the interaction between the TP rules and rules in UK tax legislation imposing a market value rule on intra-group transactions. The removal of these inconsistencies is a welcome change that sh ould eliminate the current need for multiple valuations, in certain circumstances, in respect of the same transaction.

2. Permanent establishment (PE)

   The government indicates in its consultation paper that it is seeking to alter its policy with respect to the definition of a dependent agent PE under UK tax treaties to align with the broader concept reflected under the 2017 OECD Model Convention. If adopted, in some cases such a change could have an immediate effect. In any event, for many multinational groups, adoption of the wider definition under UK tax treaties will require a reassessment of the level of UK PE risk arising from operations.

3. Diverted Profits Tax (DPT)

   The headline proposal is to bring DPT within the scope of corporation tax (CT) to more closely align it with the UK's TP regime. A welcome consequence is that CT and DPT enquiries would formally run in parallel and be concluded concurrently. Bringing the two taxes under one regime may, in and of itself, bring greater certainty to taxpayers by removing the complexities around how DPT and CT/ TP interact but it remains to be seen whether it will lead to any marked differences to taxpayer audits in practice. Another key benefit of the proposal is to confirm taxpayers' access to double tax treaty (DTT) benefits in relation to DPT charges.

# In depth

**Transfer Pricing**

Conceptual Proposals

The UK TP rules have not been updated since 2004. In fact, the concept of "arm's length" is not defined in the UK legislation. Notwithstanding, latest developments in the international tax environment have effectively been brought within its scope by virtue of the fact that the rules provide a framework for the application of the OECD TP Guidelines.

The rules apply to non-arm's length "provisions" between two persons where the "participation condition" is met and the provision gives rise to a "tax advantage" for at least one of them. The government is considering amending the terminology of both a "provision" and "tax advantage" to instead replicate the language of Article 9 of the OECD Model Convention. The term "provision" is not defined in domestic legislation and the UK is the only jurisdiction HMRC is aware of which has adopted this concept. HMRC's view is that a "provision" is broader than a "transaction" but narrower than the OECD concept of "conditions made or imposed" between two enterprises in their commercial or financial transactions, and is ultimately an unnecessary complication in the domestic legislation.

The tax advantage rule currently only allows unilateral positive income adjustments (the so-called "one-way street"). Negative income adjustments are only possible where there is a corresponding positive adjustment at the level of another UK entity or a related entity in another jurisdiction. Whilst there is no indication that the government is looking to repeal this rule – in fact HMRC has confirmed it views it as important to prevent negative unilateral adjustments where there is no positive adjustment on the other side, leading to double non-taxation - it is clear that HMRC is considering relaxing its application to UK-UK transactions where there is no overall UK tax advantage conferred by mispricing. Currently the one-way street operates at the level of a "provision". If this concept is removed from the legislation, HMRC is open to considering whether "tax advantage" should be assessed at the group rather than entity level.

The government is also proposing to remove the participation condition (which effectively means TP only applies where there is the relevant 'connection' or special relationship between entities) or to broaden it such that the question centres around whether excessive influence or control is exerted by one party over another, or on both by a third. Removing the participation condition altogether arguably creates an administrative burden as the arm's length nature of every transaction would have to be tested. HMRC acknowledged in the first stakeholder meeting that for this reason some sort of threshold would be important in order to keep compliance costs down.

Interaction between TP and other rules governing intra-group transactions

Other proposed changes concern the interaction between the TP rules and rules in UK tax legislation imposing a market value rule on intra-group transactions.

*Intangible Fixed Assets*

In relation to valuation methodologies as they apply to intangible fixed assets, the rules require some transactions to take place at market value or at arm's length or in some cases both. This not only requires multiple valuations but can also result in a different outcome to a DTT, which is based on an arm's length price.

The government further notes that determining a market value of an asset can, in some circumstances, differ from its arm's length price as a result of the difference between the two standards. Fundamentally, the market value concept seeks to determine the best price in a hypothetical market with willing market participants whereas, the arm's length price takes into account the different bargaining power of a known buyer and seller. The government specifically call out that the buyer may be able to benefit from certain synergies and so may be willing to pay more than the market value. In our experience, HMRC has often pushed this point in IP valuation audits and so it is not surprising that they are looking to enshrine the arm's length standard over the market value rule and remove any inconsistency.

In addition, HMRC raised the point at its first live stakeholder session that market value transactions cannot be dealt with under an Advance Pricing Agreement (APA) and so a move towards arm's length valuations across the board, which can be covered by APAs, will create further certainty that cannot be delivered currently.

*Financial transactions*

The government is seeking input on whether the very complex rules governing the taxation of loan relationships and derivative contracts which result from transactions not at arm's length can be reduced and simplified. It is also considering simplifying the TP rules around intercompany guarantees, as the latest OECD guidance overlaps with the special provisions in the domestic law stipulating how the arm's length principle should be applied. The key focus is to align the current rules to better reflect OECD guidance to account for implicit support, to the extent relevant, when determining the amount and terms of debt available at arm's length, as well as facilitating the pricing of guarantees where appropriate. HMRC have acknowledged that the OECD rules in this area drive a very fact specific approach to considering the importance of an entity to a group and its economic links in assessing whether it is getting implicit support. There is a risk that multinational groups could face more factual HMRC enquiries in this area, and therefore an increased compliance and audit burden if these proposals are adopted.

<u>Operational improvements</u>

The government is proposing to repeal the current requirement to apply TP rules to domestic transactions irrespective of the overall impact on the UK tax base and is looking to understand if this would materially reduce a taxpayer's compliance burden. The government acknowledges that applying TP rules to domestic transactions is not necessarily an internationally accepted standard in line with OECD guidance.

In its consultation, the government states that it is, in addition, looking to simplify HMRC's operational approach to TP enquiries which are often extremely complex and long running, tying up significant internal resource in multinational groups. HMRC are specifically looking at repealing the legislative requirement for a Commissioners' Sanction and instead relying on HMRC's improved governance processes to avoid duplication of oversight.

**Permanent Establishment**

The government is also consulting on changing the definition of a PE under UK domestic legislation, with the continuing aim of ensuring it is aligned with the OECD international framework and increasing clarity and certainty for taxpayers. The UK's outbound PE legislation is already aligned with OECD principles, having implemented the overseas branch exemption, so this would similarly bring UK inbound PE rules into line.

The UK's domestic definition largely dates back to 2003, when the initial 1977 version of the OECD Model Convention was still current. The PE definition at an OECD level has since undergone significant change. This notably includes the changes resulting from the Base Erosion and Profit Shifting Project (BEPS), the outcome of which was the Multilateral Instrument (the MLI) and the updated 2017 OECD Model Convention. Whilst the UK generally participated in the BEPS project and adopted the MLI, it made a reservation against the changes the MLI made to the PE definition and has maintained this position in its DTT negotiation policy. The definition of a PE under the current OECD Model Convention expands the term 'dependent agent' to:

- include a person who 'habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without modification by the enterprise…'
- exclude an independent agent who 'acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related'

<u>UK domestic definition</u>

In its consultation, the government states that it supports the OECD Model Convention and commentary and is essentially proposing to align the UK domestic law definition of a PE with the 2017 OECD Model Convention and the 2008 OECD Report on the Attribution of Profits to PEs (which was updated in 2010). It is proposing to do this in one of two ways: firstly, by tying the UK domestic concept to the PE definition and profit attribution rules under any applicable DTT (and in the absence of such a definition, to the OECD Model) or, secondly, tying it directly to the definition and profit attribution rules in the OECD Model, subject to any applicable DTT (in a similar way to how the TP rules currently refer to OECD TP Guidelines within the primary legislation and updates to those Guidelines are easily given effect through regulations). Whilst the first option would ensure a more seamless alignment between the UK domestic law and DTT rules, the second would have the advantage of better aligning with the everchanging international consensus. Both options would introduce a broader concept of a PE under UK law and multinational groups relying on the UK domestic PE exemption in the absence of a DTT should monitor the consultation' outcome and re-asses their PE position.

Position under UK DTTs

Alongside the changes to the domestic definition of a PE, the consultation indicates the government is considering a similar change in policy with respect to its position on UK DTTs. The consultation mentions a potential withdrawal of the UK's reservation against the changes to the PE definition under the MLI, the effect of which would be to broaden the scope of the definition of a dependent agent PE under UK DTTs in line with the OECD Model Convention. The government is not asking for stakeholder input in this respect. It was clear from the first stakeholder meeting with HMRC that it does not consider that its policy of resisting changes to the definition of PE given effect under the MLI is warranted anymore, and reversing this policy stance should enable HMRC to create a better baseline position from which to negotiate DTT articles more in line with the MLI across the board.

Given the large network of UK DTTs, this change would have a more wide-ranging impact than reforms to the UK domestic PE definition. A withdrawal of the UK's reservation to the MLI PE provisions could have immediate effect if the relevant treaty partner has not made an equivalent reservation.

Whilst the broker exemption and Investment Manager Exemption (which provide certainty that where certain conditions are met a UK broker or investment manager will be treated as an agent of independent status) will be retained, if the proposals are adopted, they give rise to the risk that new UK PEs will be created and multinational groups should revisit their PE risk analysis and operational guidelines to determine if the broader definition of a dependent agent might apply, and to assess whether it might lead to an increased level of UK PE risk.

**Diverted Profits Tax**

DPT was introduced in 2015 with the purpose of charging profits artificially diverted out of the UK to a higher rate of tax (31% from 1 April 2023) and ultimately encouraging taxpayer behavioural change. HMRC maintain that DPT is a powerful tool enabling them to drive engagement from multinational groups, particularly those headquartered outside the UK. HMRC acknowledge that over time it may be the case that the arrival of Pillar Two enables the UK government to repeal DPT, but there is no suggestion of that happening any time soon and for now HMRC consider that the two regimes will work alongside each other.

The government is, however, seeking to simplify and clarify the DPT legislation in light of changes to the international tax landscape since it was enacted, including as a result of the publication of the 2017 and 2022 OECD TP Guidelines and progress on BEPS Actions 8-10. HMRC hold the view that the updated OECD TP Guidelines give them the ability to look through contrived arrangements such that it can now use TP to deal with many situations for which it would previously have relied on DPT. This view aligns with our experience of how aggressively HMRC is interpreting the new OECD TP Guidelines, particularly with respect to intangibles and DEMPE. It's also clear that HMRC thinks tax authorities in other jurisdictions are now beginning to adopt a similar approach.

Key Proposal

The headline proposal is to bring DPT within the scope of CT to more closely align it with the UK's TP regime. DPT is currently a separate tax to CT, and while the DPT legislation makes clear that the same profits cannot be subject to both CT and DPT, there are nonetheless a number of overlaps between the two regimes (not least the ability for taxpayers to amend their CT returns in the course of a DPT review period to bring additional profits into the charge to CT, thereby avoiding paying tax on those profits at the penal DPT rate).

Bringing the two taxes under one regime may, in and of itself, bring greater certainty to taxpayers by removing the complexities around how DPT and CT/ TP interact but in practice HMRC already run DPT enquiries together with TP enquiries and so it remains to be seen whether it will in fact lead to any marked differences to taxpayer audits. One consequence of combining the taxes under the same regime is that CT and DPT enquiries would formally run in parallel and be concluded concurrently, such that HMRC should be prevented from using open CT enquiries to continue to ask questions once the DPT review period ends, but on the flip side, this could also impede a taxpayer's ability to resolve TP enquiries without having to initiate a Tribunal process.

Another key benefit of the proposal is to confirm taxpayers' access to DTT benefits in relation to DPT charges. HMRC strongly maintains the position that DPT is not a covered tax under the UK's DTTs and that, as a result, this reform is specifically needed to bring DPT within the scope of the Mutual Agreement Procedure (MAP). The change would allow a charge to DPT to be submitted for review under the MAP article of a relevant DTT. Currently DPT cases can only be resolved through bilateral MAP where the treaty partner accepts the case into MAP and the treaty contains a requirement for mandatory binding arbitration. There is to some degree a question mark over whether UK DTT counterparties will accept DPT as CT but HMRC considers this will be the case (or at the very least counterparty jurisdictions will treat DPT as a tax that is sufficiently similar to CT). This change would therefore reduce the risk that double taxation resulting from a DPT charge will not be relieved. Given HMRC's continued position that DPT is not a covered tax under UK DTTs, it will be interesting to see what stance it takes with respect to cases which straddle the introduction of the new rules and whether it would resist putting earlier DPT audit years into MAP.

Diverted profits assessment

In terms of implementation, the proposal contemplates the introduction of a new CT assessment power, the so-called "diverted profits assessment", while retaining the essential features of the existing DPT framework. The desire to retain much of the DPT framework is likely because the government credits DPT with facilitating more open information exchange between taxpayers and HMRC and helping resolve multiple long-running TP disputes.

A notable consequence of bringing DPT within CT is how the "relevant alternative provision" (RAP) will be translated. The proposal is to retain the definition of the DPT "material provision", which would then be compared to the "arm's length provision" for the purposes of the diverted profits assessment. The proposal contemplates that the existing legislative provision, which seeks to counter contrived arrangements to avoid a UK PE (i.e. the "Section 86 charge"), may not be replicated in the CT regime, but rather the diverted profits assessment would be levied on the UK dependent agent entity.

In addition, the consultation seeks views on a wholesale change to the existing DPT computational provisions, in particular given the potential changes to the RAP. The proposal to consolidate the computation rules into one standalone provision could offer welcome simplification to this complex area.

Consequential/ clarificatory proposals

The consultation also states the government is considering a variety of other less significant changes to the DPT regime to help clarify areas of uncertainty, including:

- As part of the broader changes to the current DPT computation provisions, tweaks are proposed to clarify that DPT applies equally to loss-making entities, provided the charging conditions are met.
- There are no plans to overhaul the Effective Tax Mismatch Outcome (ETMO) provisions, rather, the consultation looks to make minor amendments to clarify areas of uncertainty. One such proposal is to make clear that the "reduction in income" condition can be met even if some income is reported by the entity being tested. This reflects HMRC's long-standing position (as set out in the PDCF guidance) but the consultation cites continued disagreement between HMRC and taxpayers as to the scope of the ETMO as the rationale for the change. It is notable that the government finds it necessary to codify HMRC's interpretation in the legislation.
- The Insufficient Economic Substance Condition (IESC) provisions are detailed and complex. The consultation acknowledges this and seeks input on how best to clarify the scope of the IESC, including suggestions as to how the definition of the "tax reduction" could best be amended.
- Currently, amending notices can only be issued to reduce a DPT charge once the DPT has been paid. This can lead to difficulties, including where there are errors or mistakes in charging notices, or the company is in liquidation, so changes are contemplated to permit HMRC to issue amending notices in a further limited set of circumstances.

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