

TAX MEMORANDUM

DIVERTED PROFITS TAX AND UK PROPERTY TRANSACTIONS

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DIVERTED PROFITS TAX AND UK PROPERTY TRANSACTIONS

INTRODUCTION

The diverted profits tax (DPT) legislation is contained in FA 2015 ss77-116. References to sections in this Tax Memorandum are to references to sections in that Act unless otherwise indicated.

The HMRC guidance – Diverted Profits Tax: Interim Guidance – is dated 30/3/2015 and this was updated on 20/4/2015.

WHAT IS THE DPT?

This is a completely new tax which seeks to catch profits of companies which have been diverted from the UK to lower tax jurisdictions and tax those profits at the penal rate of 25% (this is penal because the rate of UK corporation tax is only 20%)(s79(2)(a)).

The new tax applies to profits diverted from the UK after 31 March 2015(s116(1)).

The new tax can apply to UK land transactions as well as the provision of goods and services in general. It is popularly known as the “Google tax” but it is not restricted to web-based businesses.

Only companies can have their profits adjusted under these provisions (ss 77, 82 and 88).

WHAT ARE THE HEADS OF CHARGE?

There are three heads of charge (s77(2)). Avoid all three of these and the tax is avoided.

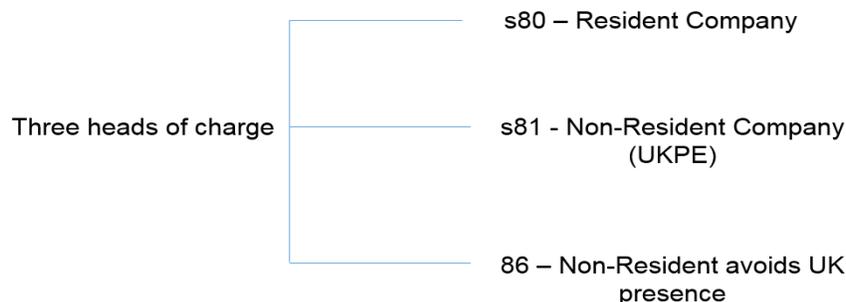
The three heads of charge are thus:

First Head: UK resident company diverting profits (s80)

Second Head: Non-UK resident company carrying on a trade in the UK and diverting profits (s81)

Third head: Non-UK resident companies diverting trading profits by avoiding a UK tax presence (s86)

Fig. 1



FIRST HEAD OF CHARGE: UK RESIDENT COMPANY DIVERTING PROFITS (S80)

To fall within the first head of charge there must be the following:

Condition (a): a UK resident company (C),

Condition (b) a provision made between C and another person (P) by means of a transaction or a series of transactions,

Condition (c): C and P must be connected (i.e. they satisfy the participation condition of connection similar to that found in the transfer pricing code: see s106),

Condition (d): there must be an “effective tax mismatch outcome” (e.g. C gets a corporation tax deduction on a royalty paid to P (a BVI company) and P pays no tax on the same).

Condition (e): the effective tax mismatch outcome must not be an excepted loan relationship outcome (i.e. certain loan relationships are outside of the DPT),

Condition (f): there must be “insufficient economic substance” in the arrangement (e.g. P is a front or post-box company in a tax haven), and

Condition (g): C and P must not be small or medium-sized enterprises (SMEs).

Note on condition (d)

An “effective tax mismatch outcome” (condition (d)) broadly arises where

- (1) the tax deduction (of C) resulting from the arrangement exceeds any increase in tax (payable by P) and
- (2) the tax payable by P is less than 80% of the tax reduction achieved by C (s107).

Note taxes for these purposes include UK income tax and corporation tax on income and any non-UK tax on income (see s107(8)).

Example

C pays P a royalty of £10m and gets a tax reduction of £2. P pays £0.2 local tax on the £10m. Condition 1 is satisfied as £2m exceeds £0.2m. Condition 2 is satisfied as 80% of £20m is £1.6m and £0.2m is less than £1.6m.

Note on condition (f)

There is “insufficient economic substance” (condition (f)) in the arrangements if

- the arrangements lack economic substance and
- are designed to reduce tax (s110).

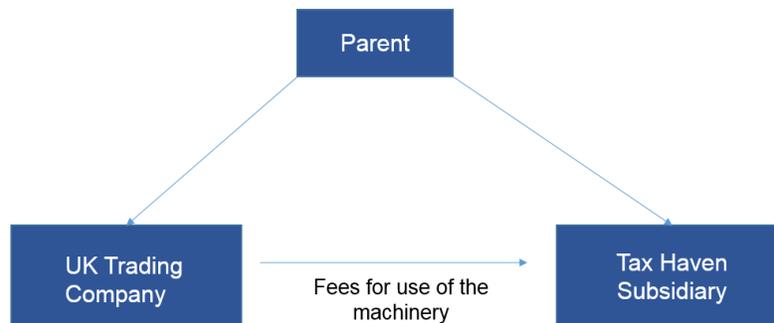
When determining if there is economic substance there are (broadly) 2 tests:

- There is a transaction based test: if the non-tax financial benefits of the transaction do not exceed the financial benefits of the tax reduction there is no economic substance. Putting it the other way: if the non-tax financial benefits of the transaction are greater than the financial benefits obtained from the tax reduction then there is economic substance under this head.
- There is an entity based test: if the non-tax financial benefits of the contributions made to the transaction in terms of the functions or activities of that person's staff do not exceed the financial benefits of the tax reduction there is no economic substance. For example if the local staff do not have the skill to undertake the relevant transaction and rely on advice located elsewhere this condition may not be satisfied.

Example (first head of charge)

A connected company (P) in a tax haven buys new expensive plant and leases it at an annual market rental to C a UK trading company. P and C are owned by the same parent company and that parent funds the purchase of the plant by P by way of share capital with a view to getting a tax deduction. This leaves C with small profits and P makes large profits. P has no full time staff but has a routine administration function to perform. There is an “effective tax mismatch outcome” as the rents are deductible by C and are tax free in the hands of P. There is “insufficient economic substance” as the steps were designed to secure a tax reduction and the financial contribution to P by the staff of P is less than the financial benefits obtained by the tax deduction available to C (transaction-based test). Also the income attributable to the ongoing functions and activities of the staff of P (this is likely to be not much more than the small salaries paid to them for their not too time consuming administrative activities) will not exceed the other income attributable to the transaction (the rental income) (the entity-based test). The above is based on the HMRC guidance Example 1 in DPT1300.

Fig. 2



SECOND HEAD OF CHARGE: NON-UK RESIDENT COMPANY CARRYING ON A TRADE IN THE UK AND DIVERTING PROFITS (S81)

To fall within this head of charge the following conditions must be satisfied:

Condition (a): there must be a non-UK resident company (the foreign company),

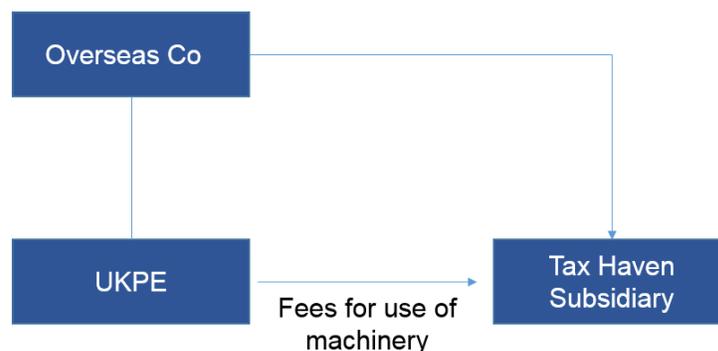
Condition (b): the foreign company must trade (carrying on a letting business is not enough: so foreign property investment companies are not within this head or indeed any of the other heads) in the UK through a permanent establishment (UKPE) and

Condition (c): the first head of charge (s80) would apply to the UKPE if the UKPE were deemed to be a separate company resident in the UK and under the control of the foreign company. Thus one applies the effective tax mismatch outcome test and the insufficient economic substance test based on the UKPE as if it were a separate UK resident company. The exemption for SMEs applies as does the excepted loan relationship outcome rules.

Example (second head of charge)

An overseas company has a UKPE and it pays rentals for the use of expensive equipment to a tax haven subsidiary owned by the overseas company. This reduces the corporation tax payable by the overseas company on the UKPE profits. This arrangement may be within the second head of charge.

Fig. 3



IF THE DPT APPLIES HOW IS THE CHARGE CALCULATED IN THE CASE OF THE FIRST HEAD OF CHARGE AND THE SECOND HEAD OF CHARGE?

Sections 82-85 set out the calculations for the DPT and s96 deals with the estimation of the profits when HMRC initially impose a charge.

Generally the charge will arise by applying the transfer pricing rules. One looks at the actual deal done between the connected parties (connection is determined using the transfer pricing rules-see s106): this is called the material provision (s80(1)(b) and s82(4)).

One then compares this with the relevant alternative provision to see how much is brought into charge.

The relevant alternative provision is defined in s82 thus:

(5) “The relevant alternative provision” means the alternative provision which it is just and reasonable to assume would have been made or imposed as between the relevant company and one or more companies connected with that company, instead of the material provision, had tax (including any non-UK tax) on income not been a relevant consideration for any person at any time.

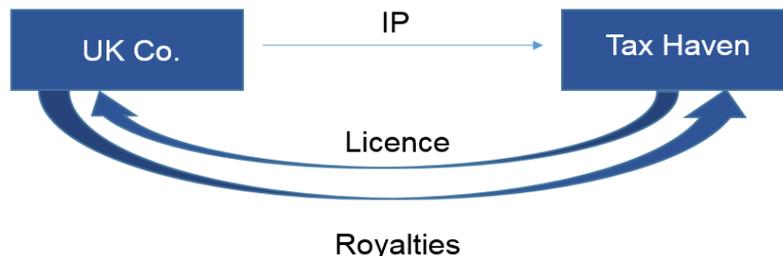
Thus if a royalty of £1m is paid and declared in the corporation tax return and the relevant alternative provision is £3m the difference of £2 bears DPT. See s84.

However there will be a wholesale re-characterisation of transactions where they will not have been entered into but for the tax advantage being sought. See s85.

Example

A UK company transfers IP overseas. In the absence of the tax benefits this would not have been done. This may be characterised as a transaction where the IP income will have remained in the UK and be fully taxed: this produces needless to say a better result for HMRC than if the usual transfer pricing rules were applied to the royalty payments. See DPT1138.

Fig. 4



The third part of the HMRC counter-action armoury applies if an expense has been inflated i.e. the expense exceeds the arm's length figure (s 96).

This is a red rag to the bull.

In this case in determining the estimated diverted profits there is an upfront 30% disallowance of the inflated payments.

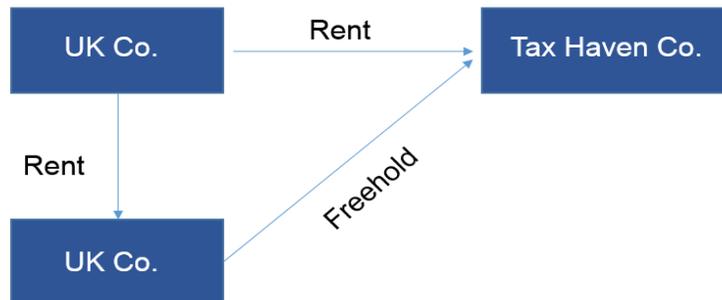
On page 15 of the guidance at DPT1139 HMRC give a property based example of how the 30% disallowance would operate:

Example of inflated expense condition

A UK resident company is making rental payments for property used by it in the course of its trade to a connected UK company that owns the freehold. The freehold is subsequently transferred to an affiliate in a tax haven, and the rental payments are then increased, on the alleged grounds that with the change of ownership the group is taking the opportunity to review the rental payments and move them to current market rates.

The mismatch condition is met and it is also assumed that the insufficient economic substance test is met. In consequence of those facts, and taking into account the increase in rentals at the time of transfer to the tax haven, it is likely to be reasonable for the designated officer to conclude that the inflated expense condition is met. Accordingly, the initial estimated charge to taxable diverted profits will be equal to 30% of the rental payment, less any amount adjusted by the company under Part 4 of TIOPA 2010 and included in its tax return before the notice is issued. If the relevant conditions were met the charge would also include any relevant taxable income diverted to the affiliate company.

Fig. 5



THIRD HEAD OF CHARGE: NON-RESIDENT COMPANY DIVERTING PROFITS BY AVOIDING A UK TAX PRESENCE (S86)

This head applies in relation a company (the foreign company) if the following conditions are satisfied:

Condition (a): the company is non-UK resident,

Condition (b): it carries on a trade,

Condition (c): a person (“the avoided PE”), whether or not UK resident, is carrying on activity in the United Kingdom in that period in connection with supplies of services, goods or other property (note other property will include land) made by the foreign company in the course of that trade,

Condition (d): section 87 does not operate to prevent this section applying in relation to the foreign company(this section gives an exception for companies with limited UK-related sales or expenses: this provides for inter alia a £10m per 12 month accounting period exemption for sales of UK related services, goods and other property),

Condition (e): it is reasonable to assume that any of the activity of the avoided PE or the foreign company (or both) is designed so as to ensure that the foreign company does not, as a result of the avoided PE's activity, carry on that trade in the United Kingdom for the purposes of corporation tax (whether or not it is also designed to secure any commercial or other objective),

Condition (f): the mismatch condition or the tax avoidance condition is met or both those conditions are met,

Condition (g): the avoided PE is not excepted by subsection 86(5) (special independent agents: see below), and

Condition (h): the avoided PE and the foreign company are not both small or medium-sized enterprises.

General

This head is designed to cover cases where an overseas company carries out significant trading activities in the UK but avoids UK corporation tax on the profits because for example the sale contracts are concluded outside the UK so the profits do not arise in the UK (see *Smidth v Greenwood* 8 TC 1930, *Firestone v Lewellin* 37 TC 111 and the HMRC Guidance DPT1140).

Note on condition (c)

Condition (c) requires there to be a person in the UK acting for the foreign company in connection with its trade but note the let out in Condition (g) for “excepted” PEs.

Note on condition (g)

The excepted PE provision works as follows.

An agent in the UK may cause the overseas company to have a PE in the UK. This means corporation tax will be in issue: if he is not a PE only income tax may be in issue and the DPT will be irrelevant.

CTA 2010 s1141 defines a PE thus:

1141 Permanent establishments of companies

- (1) For the purposes of the Corporation Tax Acts a company has a permanent establishment in a territory if (and only if)—
 - (a) it has a fixed place of business there through which the business of the company is wholly or partly carried on, or
 - (b) an agent acting on behalf of the company has and **habitually exercises there authority to do business on behalf of the company.**
- (2) For this purpose a “fixed place of business” includes (without prejudice to the generality of that expression)—
 - (a) a place of management,
 - (b) a branch,
 - (c) an office,
 - (d) a factory,
 - (e) a workshop,
 - (f) an installation or structure for the exploration of natural resources,
 - (g) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources, and
 - (h) a building site or construction or installation project.
- (3) Subsection (1) is subject to sections 1142 to 1144.

However under CTA 2010 s1142 an agent of independent status is not a PE:

Circumstances where there is no permanent establishment

1142 Agent of independent status

- (1) A company is not regarded as having a permanent establishment in a territory by reason of the fact that it carries on business there through an agent of independent status acting in the ordinary course of the agent's business

Thus on the face of it if one has an independent agent the DPT should not apply. However s86(5)(b) states that if the independent agent is connected to the company the DPT can still apply unless he is an independent broker within CTA 2010 s1145 or an independent manager within s1146.

Thus:

- one first sees whether there is an agent in the UK (s86(1)(c))

- if there is, that agent must cause a PE to arise in the UK under s1141
- however if he is an agent of independent status and not connected with the foreign company the DPT cannot apply
- and also if he is an agent of independent status who is an independent broker within CTA 2010 s 1145 or an independent manager within s1146 the DPT is avoided even though he is connected with the foreign company.

Connected is to be read in accordance with CTA 2010 ss1122 and 1123 (see s114(1)).

Note on condition (f)

With regards to condition (f) the HMRC guidance re the mismatch condition and the tax avoidance condition are in DPT1150 which reads thus:

DPT1150 – section 86 – the mismatch and tax avoidance conditions

The mismatch condition

The mismatch condition is intended to apply to cases that involve entities or transactions lacking economic substance, and is similar to the rule in section 80 applicable to UK companies. The condition is met if:

- in connection with the supplies of the goods, services, etc., arrangements are in place as a result of which provision ('the material provision') is made or imposed as between the foreign company and another person ('A') by means of a transaction or series of transactions,
- the participation condition is met in relation to the foreign company and A (DPT1170),
- the material provision results in an effective tax mismatch outcome as between the foreign company and A (DPT1180),
- the insufficient economic substance condition is met (DPT1190),
- the effective tax mismatch outcome is not an excepted loan relationship outcome;
- the foreign company and A are not both small or medium-sized enterprises.

The tax avoidance condition

This condition is met if, in connection with the supply of goods, services or other property, arrangements are in place one of the main purposes of which is to avoid or reduce a charge to tax in the UK.

The legislation does not define what is meant by 'main purpose' or 'one of the main purposes'. These expressions are to be given their normal

meaning as ordinary English words. They have to be applied objectively, having regard to the full context and facts.

It will usually be clear whether trying to obtain a tax advantage is 'the main purpose' of a particular arrangement. Such would be the case, for example, where the arrangement would not have been carried out at all were it not for the opportunity to obtain the tax advantage, or where any non-tax objective was secondary to the benefit of obtaining the tax advantage

HMRC would seek to apply this rule if the company has put in place arrangements that separate the substance of its activities from where the business is formally done, with a view to ensuring that it avoids the creation of a UK PE and it is clear that doing so has resulted in a tax saving.

Note on condition (e)

The key issue here is whether the avoided PE and/or the foreign company carry out the trading activities in the UK in a way designed to avoid a PE within CTA 2010 s1141 (and thus avoiding corporation tax). If such offending activities are carried out the condition is satisfied even though they may also be designed to secure a commercial or other objective (such as relying on a double tax treaty).

Thus if it is reasonable to assume there is no attempt to design the transaction to avoid creating a PE under the corporation tax rules in CTA 2010 s1141 the DPT will not apply. It seems clear enough that if the transaction is designed to fall within the treaty but remain within the general corporation tax net (any tax charge however being trumped by the treaty) condition (e) is not satisfied and DPT is avoided.

The Jersey arrangement SI 1952/12 para 2(j) provides thus:

(j) The term “permanent establishment”, when used with respect to an enterprise of one of the territories, means a branch, management or other fixed place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to **negotiate and conclude contracts** on behalf of such enterprise or has a stock of merchandise from which he regularly fills orders on its behalf.

An enterprise of one of the territories shall not be deemed to have a permanent establishment in the other territory merely because it carries on business dealings in that other territory through a *bona fide* broker or general commission agent acting in the ordinary course of his business as such.

The fact that an enterprise of one of the territories maintains in the other territory a fixed place of business exclusively for the purchase of goods or merchandise shall not of itself constitute that fixed place of business a permanent establishment of the enterprise.

The fact that a company which is a resident of one of the territories has a subsidiary company which is a resident of the other territory or which is engaged in trade or business in that other territory (whether through a

permanent establishment or otherwise) shall not of itself constitute that subsidiary company a permanent establishment of its parent company.

Thus if the transactions are designed to come within the treaty and avoid a UK PE within s1141 DPT may be in issue. If the steps are designed to come within the treaty and not to avoid a UK PE within s1141 the DPT is avoided: it is not a question of the DPT overriding the treaty, there is no DPT charge in the first place.

IF THE DPT APPLIES HOW IS THE CHARGE CALCULATED IN THE CASE OF THE THIRD HEAD OF CHARGE?

Where the third head of charge applies there are three ways in which the diverted profits may be determined and then taxed at 25%. These are found in ss 88, 89, 90 and 91.

Where the tax avoidance condition is met (and not the mismatch condition) the charge under s89 is on the notional PE profits which are defined in s88(5) thus:

(5) "The notional PE profits", in relation to an accounting period, means the profits which would have been the chargeable profits of the foreign company for that period, attributable.....to the avoided PE, had the avoided PE been a permanent establishment in the United Kingdom through which the foreign company carried on the trade.....

WHAT ARE THE EXEMPTIONS?

There is the general SME exemption and certain loan relationships are exempt.

There are exemptions for charities and pension schemes and persons having sovereign immunity.

There are some exemptions only applicable to head of charge three. These relate to independent agents and alternative finance (s86(5)) and there are exemptions where the total UK related profits do not exceed £10m in a 12 period and/or the UK related expenses are no greater than £1m in a 12 month period (s87).

SMEs ARE EXEMPT FROM THE DPT; HOW ARE THEY DEFINED?

Small and medium sized companies are defined thus by reference to EU material referred to in TIOPA 2010 s176.

"SME" stands for small and medium-sized enterprises – as defined in EU law: **EU recommendation 2003/361**.

The main factors determining whether a company is an SME are:

number of employees **and**

either turnover **or** balance sheet total.

Company category	Employees	Turnover	or	Balance sheet total
Medium-sized	< 250	≤ € 50 m		≤ € 43 m
Small	< 50	≤ € 10 m		≤ € 10 m
Micro	< 10	≤ € 2 m		≤ € 2 m

IS THERE RELIEF FOR DOUBLE TAX CHARGES?

Section 100 gives credit for any UK or foreign taxes charged on the diverted profits.

Section 99 makes it clear DPT cannot be deducted in any UK corporation tax computation as an expense.

HMRC take the view that treaties cannot protect against a DPT charge as the charge fills in the gaps where the treaties do not apply. In other words it is not a tax covered by the treaties and is not substantially similar to a tax covered by the treaties. It is *sui generis*. This is a brave proposition by HMRC and is unlikely to withstand the courts’ scrutiny – is it not, when all is said and done, a corporation tax charge at 25%?.

DOES ONE SELF-ASSESS FOR THE DPT?

One does not self-assess but there are notification obligations.

WHAT ARE THE NOTIFICATION OBLIGATIONS?

The notification provisions are in s92 and these require companies to notify a potential liability to DPT.

HMRC have set out the obligations in their guidance at DPT2010 and DPT2020.

WHEN IS THE DPT PAYABLE?

The tax is payable within 30 days of HMRC issuing a charging notice (s98).

Section 98(4) states:

- (4) The payment of the tax may not be postponed on any grounds, and so the diverted profits tax charged by the charging notice remains due and payable despite any review being conducted..... or any appeal in respect of the notice.

Clearly HMRC view this tax as aimed at unacceptable avoidance schemes.

HMRC should bear in mind the words of Lord Scarman in IRC v Garvin [1981] STC 344 at 351 thus:

Those who use the services of an 'inventor and purveyor of tax avoidance schemes' (Templeman LJ's phrase) can expect no mercy: but they are entitled, like the rest of us, to justice.

SO WHAT UK LAND TRANSACTIONS CAN BE WITHIN THE DPT?

Investment

Non-UK resident companies which invest in UK land are not within any of the three heads of charge as they do not carry on trades: they may carry on businesses but that is different.

Vinelott J in Griffiths v Jackson 56 TC 583 at 590 stated:

It is a cardinal principle of United Kingdom tax law that "income derived from the exercise of property rights properly so-called" by the owner of land (freehold or leasehold) is not income derived from the carrying on of a trade.

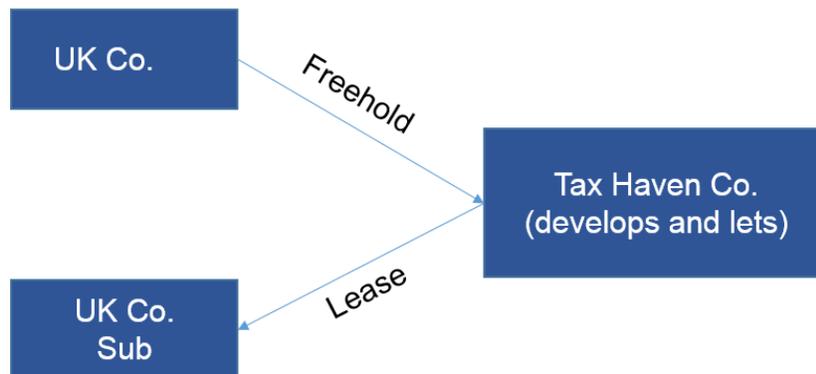
A situation may come within the first head if a UK-resident company disposes of an investment land interest to a tax haven company to get profits tax free offshore.

HMRC give the following example on page 42 of their guidance.

A UK company which has traditionally held and managed all its property assets onshore sets up a company in a very low tax territory and transfers ownership of a UK property that is in the course of development to that company

- All costs in relation to the development are incurred by the new company but all the work on the development and all critical decisions are being taken by the management team for the group in the UK
- When the property is developed, it is leased back to a property subsidiary in the UK (UK Property Co 2) and then on-let to tenants which the UK group finds for the property
- The rental payments out to the offshore company are set at a level which effectively leaves the UK with only a nominal margin
- The facts show that the management of the company in the very low tax territory do not have the authority or expertise to do this project on their own or indeed to manage the portfolio –they are effectively acting as conduits

Fig. 6



Analysis (HMRC)

While the rental payments might be argued to be on arm's length terms, the conclusion that it is reasonable to draw from these arrangements is that what has caused them to be established is the attraction of having tax-free profits offshore. This is a change in the group's normal pattern of holding properties and the profits allocated to the offshore company are very much out of line with its contribution. It has capital but it is really unable to manage that capital itself. The transaction can thus be considered for DPT purposes as amounting to an arrangement where all the offshore company is doing is holding the property on behalf of a member of the UK group. As the transactions would not have occurred absent tax, DPT is to be applied by reference to the relevant alternative provision. This means no deduction for the rental payments would be due.

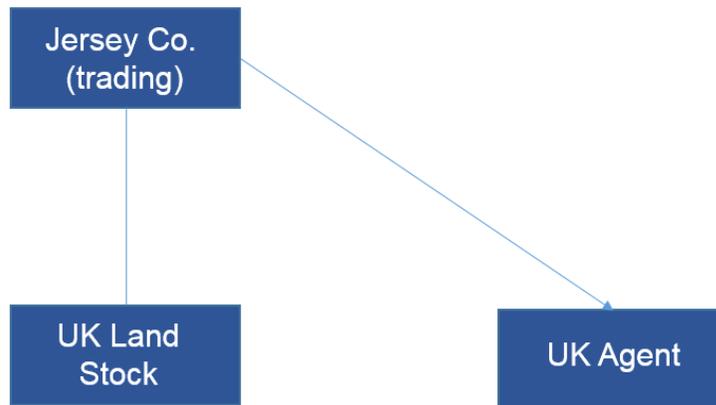
Author's Note

This is not a very good example as the overseas company is liable to UK income tax at 20% and so there is no tax mismatch; the position may be different however if the overseas company has a deductible foreign borrowing so foreign source interest reduces the taxable rent. Also if the rent were inflated different considerations would apply: see s97 and the 30% upfront charge and the example in DPT1139.

Trading

The third head of charge (s86) is the one which offshore companies trading in UK land should look out for if they have a person ("the avoided PE": see s86(1) Condition (c)) in the UK carrying on activity in connection with the supplies of land made by the foreign company in the course of its land dealing trade.

Fig. 7



Example

A non-UK resident company buys UK land taking care to ensure its UK agent does not do anything to make him a PE of the company in the UK. The land is simply sold at a profit or developed and sold at a profit. On the face of it the land profit which arises on the sale of the land can come within the third head of charge (s86).

Notes on the example

No treaty protection

It is difficult to see that much turns on this as the profit will be made in the UK in any event as that is where the land is (*Rhodesia Metals Ltd v Commissioner of Taxes* [1940] AC 774); that profit is taxed at 20%.

Treaty protection

If the profit is treaty protected the protection should prevail over any DPT liability.

However, HMRC take the view there is no conflict between treaty protection and the DPT: the DPT is *sui generis* and it overrides the treaty – as not being a tax covered by the treaty or of a similar character to the taxes covered by the treaty.

If HMRC are correct one must ignore the treaty protection and ask if s86 applies.

It will not apply if one uses an excepted agent – see s86(1)(g).

If one does not use an excepted agent the chances are one has a person who is “the avoided PE” within s86(1)(c).

The only let out is likely to be s86(1)(f) which requires one to ask whether it is:

.....reasonable to assume that any of the activity of the avoided PE or the foreign company (or both) is designed so as to ensure that the foreign company does not, *as a result of the avoided PE's activity*, carry on that trade in the United Kingdom for the purposes of corporation tax (whether or not it is also designed to secure any commercial or other objective) (s86(1)(f)).

One can avoid this condition if the profit remains subject to corporation tax under general principles because of the activities of the agent (and no steps are taken to avoid that position) albeit no tax is payable because of a treaty claim. If steps re the agent are taken and these are designed to avoid a charge to corporation tax and fall within the treaty, DPT may be in point.

In many cases the agent is irrelevant and a corporation tax charge arises under general principles because there is a building site in the UK. Any activity of the agent is thus irrelevant to the corporation tax position and if the profit is treaty protected DPT is not in issue: again it is not a question of overriding the treaty-DPT is simply not in issue.

CONCLUSION

The new tax will not affect offshore property investors as they will not be trading in the UK.

It will affect UK resident companies which seek to transfer UK property investments into overseas tax haven subsidiaries. HMRC give 2 examples of this in their guidance.

Offshore companies trading in UK land may be within the ambit of the new tax and the particular cases must be reviewed. HMRC give no examples of land trading situations in their guidance and one gets the distinct impression this legislation was not designed to cover such situations although it can in limited circumstances.

Practitioners must look at their land trading cases on a deal by deal basis but for one reason or another it is not expected that many will be caught by the DPT.

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Field Court Tax Chambers

4 June 2015



FIELD COURT TAX CHAMBERS