

Guidance on avoidance schemes involving the transfer of corporate profits

Technical Note

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Guidance note on measure announced at Budget: Avoidance schemes involving the transfer of corporate profits

Summary of effects of measure

1. This measure was announced at Budget 2014, with immediate effect. It applies where companies in the same group enter into arrangements where payments are made, directly or indirectly, of all or a significant part of the profits of the business of a company in the group to another company in the group.
2. In those circumstances, the company from which profits were transferred is taxed as though the transfer had not taken place, for example, if a deduction had been claimed for a transfer of profits, then the effect of the clauses is that the profits transferred are added back for corporation tax purposes. It applies where the arrangements were entered into for tax avoidance purposes.

Background: why the measure was introduced

3. The measure follows the announcement of section 695A CTA 2009 on 5 December 2013, to be introduced in Finance Bill 2014 with effect from the date of announcement.
4. That measure was intended to close down an avoidance scheme. In the scheme, a company enters into a derivative contract known as a total return swap, with a parent company or another group company, generally located in a tax haven. Under the contract, all of the profits of the company are paid away in return for much smaller payments back. A deduction is claimed for the payment under the contract, leaving little or no profit chargeable to tax.
5. HMRC has now become aware that avoidance schemes are being marketed to circumvent the provisions of s695A by using arrangements other than derivatives to achieve the same effects, that is, to try and obtain a deduction for a payment designed in substance to move profits earned in the UK to a tax haven, or otherwise to divert profits to generate a tax advantage.
6. The Government considers that it is not acceptable for groups to move profits around the group in this way to avoid UK tax. The measure aims to prevent this by providing that where there is a payment in substance of the profits of a company to another company in the same group, directly or indirectly, then the former company will be assessed as though the transfer had not taken place.

Outline of the legislation

7. The full legislation is in new section 1305A CTA 2009, and can be found at Appendix 1. To summarise the main points:
 - where companies in a group enter into arrangements, and the arrangements result in what is, in substance, a payment (directly or indirectly) from one company A to another company B of all or a significant part of the profits of A

- then company A will be taxed as though the transfer had not taken place; this may include adding back any sum deducted in respect of the transfer, or adding back to profits any profits which have been diverted
- it applies only to arrangements with a tax avoidance purpose

Link with section 695A

8. The primary aim of this measure is to prevent the provisions of s695A from being avoided. Subsection (1)(d) provides that it will target arrangements of which the main purpose, or a main purpose, is to secure a tax advantage involving the profit transfer. This applies to a tax advantage obtained by circumventing section 695A, but is not restricted to that particular advantage.
9. This means that a company formerly using a scheme now caught by s695A which enters into other arrangements which involve a profit transfer will be caught by the measure. However, it may also apply to companies entering into a scheme for the first time, and which did not formerly use a scheme involving a total return swap or other derivative.
10. The measure only works one way – where profits are added back for tax purposes, there is no adjustment to the profits of the company to which profits were diverted. This is appropriate as the legislation includes a tax avoidance test.
11. Where s695A applies to a derivative arrangement, s1305A cannot apply. On the other hand, s1305A may apply to profit transfers involving derivatives in tax avoidance cases if s695A does not apply because of the specific exclusion in s695A(1)(e).

What do we mean by profits?

12. The target of the legislation is arrangements that have the overall effect that all or a significant part of the profits of the company are paid to another company under the arrangements. The legislation refers to this payment as a “profit transfer”.
13. However, it would not typically apply where the arrangements were used to move amounts within a group, but where this did not amount to an in-substance transfer of the profits of a business. (See the examples below for illustrations of this point.)
14. The clause will deny tax deductions for amounts that in substance represent distributions of the profits of the company, because in substance they are paid after profits have been earned rather than being deductions incurred in the making of profits. By contrast, payments incurred in earning the profits do not result in a profit transfer since these expenses need to be deducted in determining what the profits are.
15. For these purposes we are concerned with profit for the purposes of CT and the elements of income and expense used in arriving at the profit.

16. However, a payment would not be outside the scope of s1305A just because it features as a deduction in the profit and loss account or elsewhere. All of the circumstances surrounding the payment will be considered.

Payments linked to profits

17. There are many circumstances in which a deduction is linked to the profits of the company. For example, a payment for advice or a service may be linked to profits arising from that advice or service. It does not follow that a payment linked to profits is a transfer of profits, it may be a legitimate expense incurred in earning those profits.
18. In general, where arrangements are an essential commercial part of the company's business then they are unlikely to be caught by the measure.

Securitisations

19. If there is an intra group transfer of the legal and/or beneficial interest in assets to a securitisation vehicle taxed under the Taxation of Securitisation Companies Regulations 2006 (SI2006/3296) and the originator of the assets keeps an indirect interest in the assets in the form of a right to income from a product, then it would need to be considered whether this is a transfer of profits rather than an exchange of different flows of payments, for example, the return on one tranche of loans for the return on other assets.
20. However, the securitisation company, if covered by the provisions of the Taxation of Securitisation Companies Regulations 2006 (SI2006/3296) will be subject to the anti-avoidance test in those regulations, so if it passed that test it would also be ruled out from the effects of s1305A.
21. As far as the originator companies are concerned, it is also likely that the anti-avoidance test in s1305A will exclude securitisation arrangements from being caught by the legislation. To give certainty, as with other new legislation, advice will be available from HMRC on the application of this provision.

Reinsurance

22. Where a company has entered reinsurance arrangements within a group, for example, quota share reinsurance or excess of loss reinsurance, as part of ordinary commercial arrangements then this would not normally form the target of this measure. This will include cases where the profitability of the ceding company is a factor taken into account in arriving at the premium to be paid.

Hedging arrangements

23. Where hedging is carried out using hedges that are not derivative contracts, (for example, contracts excluded under s589 CTA 2009) then s1305A could potentially apply. However, most commercial arrangements are likely to be excluded from the effects of the measure by the tax avoidance test in s1305A(1)(d).

Funding and financing arrangements

24. There are a number of different financing structures which depending on the facts, HMRC may regard as profit transfer arrangements.
25. These include arrangements involving sub-participation, limited recourse funding, and conduit arrangements, where in different ways part or all of the return from borrowing can be passed on within a group.
26. However, these arrangements will not fall within the clause except in cases where there is a tax avoidance purpose.

Advance Pricing Agreements

27. In some cases, an Advance Pricing Agreement (APA) entered into between HMRC and a company may include an element of profit transfer to give a result overall between group companies which is in line with the agreement. Where an APA has been entered into then the conclusion would be that the agreement results in profits being taxed in the “correct” tax jurisdiction, so that no transfer of profits has taken place. It follows that s1305A does not catch these arrangements.

Overlap with other anti-avoidance provisions

28. Some arrangements which are correctly caught by this provision may also be potentially caught by other anti-avoidance provisions. In practice it is likely that any challenges would be run in parallel.
29. For example, interest charged at an excessive rate might be correctly regarded as partly a commercial interest charge, and partly a payment to distribute profits, and this latter part of the charge would be susceptible to a challenge under s1305A. The interest payment might also be subject to challenge under transfer pricing or unallowable purpose legislation, for example.

Tax advantage

30. For the purposes of the measure, tax advantage takes the definition in section 1139 CTA 2010, which includes, among other categories, a relief from tax or increased relief from tax, a repayment of tax or an increased repayment of tax, the avoidance or reduction of a charge to tax or an assessment to tax, and the avoidance of a possible assessment to tax. In deciding whether the tax advantage test is met, HMRC would have regard to all of the relevant circumstances.

Commencement

31. The clauses take effect in respect of payments made on or after Budget Day (19 March 2014), whenever the arrangements were entered into.

EXAMPLES

Example 1 – Deduction for transfer of profits: an example of one type of arrangement the legislation was intended to cover

32. A company was formerly using a total return swap to move profits from a profitable UK subsidiary to a fellow group company located in a tax haven. On 5 December 2013 it wound up that scheme. It then entered a scheme on 31 December 2013

in which arrangements not involving a total return swap were used to move profits to the subsidiary in the tax haven. The new scheme involves contracts falling outside the derivatives code which have the same overall effect of producing a deduction for a sum which is really a transfer of profits.

33. This arrangement will be caught by the new measure, and subsection 3(a) will apply, so that any profits transferred will be added back to the profits of the company on or after 19th March 2014.

Example 2 - Franchise arrangements

34. A franchisee makes various payments to the franchisor as payment for its right to use the name and for various amenities.
35. It is unlikely that these payments would be caught, as in most cases the franchisor and franchisee would not be in the same group. However, if they were, these payments would generally be based on turnover and would not be a profit transfer arrangement.
36. If unusually the payments are based on profits, they might potentially be within the measure if a significant part of the profits was transferred, but would only be caught if there was a tax avoidance motive.

Example 3 - Royalties

37. A company based in the US licenses a UK group company to sell its product in the UK. It receives royalty payments based on a percentage of turnover. These would not generally be profit transfer arrangements.
38. Royalties based on profit. These might potentially be within the measure if a significant part of the profits was transferred, but would only be caught if they had a tax avoidance motive.

Example 4 - Profits diverted: a second example of an arrangement the legislation is intended to catch

39. A company is entitled to receive a compensation payment which is calculated as a percentage of profits. It arranges for this payment to be made to a different company in the group, for tax avoidance reasons. This will be caught by the measure from 19 March 2014, and the effect of section (3)(b) is that a sum equal to the compensation payment will be added back to the profits of the company.

Example 5 - Contracts undertaken by non-resident companies

40. An online retailer 'fulfils' contracts in the UK, but the contracts are undertaken by a non-resident related company. Provided that the profit arises offshore and does not involve a transfer of profits, the legislation cannot apply. If the arrangement does effect a transfer of profits, the legislation will apply if tax avoidance is involved.

Example 6 - Charitable subsidiaries

41. For many years charities (which are normally tax exempt) have set up subsidiaries to carry on trading activities. The subsidiary then returns the profit it makes to the charity by making a payment under a deed of covenant or under the Gift Aid scheme. The payment is tax deductible for the subsidiary and is tax exempt for the charity. This type of arrangement is not of itself considered to be tax avoidance since the subsidiary and the charity are both taking advantage of tax reliefs which are intended to be used this way.

Appendix One: Legislation

Avoidance schemes involving the transfer of corporate profits

(1) In Chapter 1 of Part 20 of CTA 2009 (general calculation rules: restriction on deductions), after section 1305 insert.

1305A Avoidance schemes involving the transfer of corporate profits

(1) This section applies if

- (a) two companies (.A. and .B.) are party to any arrangements (whether or not at the same time),
- (b) A and B are members of the same group,
- (c) the arrangements result in what is, in substance, a payment (directly or indirectly) from A to B of all or a significant part of the profits of the business of A or of a company which is a member of the same group as A or B (or both) (“the profit transfer”), and
- (d) the main purpose or one of the main purposes of the arrangements is to secure a tax advantage for any person involving the profit transfer (whether by circumventing section 695A (disguised distribution arrangements: derivative contracts) or otherwise).

(2) A’s profits are to be calculated for corporation tax purposes as if the profit transfer had not occurred.

(3) Accordingly.

- (a) if (apart from this section) an amount relating to the profit transfer would be brought into account by A as a deduction in that calculation, no deduction is allowed in respect of that amount, and
- (b) A’s profits are to be increased by so much of the amount of the profit transfer as is not an amount to which paragraph (a) applies (whether or not the profits transferred would be A’s profits apart from the arrangements).

(4) For the purposes of this section a company is a member of the same group as another company if it is (or has been) a member of the same group at a time when the arrangements mentioned in subsection (1) have effect.

(5) Where in relation to arrangements involving one or more derivative contracts the requirements of section 695A(1)(a) to (e) are met, nothing in this section applies in relation to any debit in respect of any of those contracts.

(6) In this section.

"arrangements" includes any scheme, arrangement or understanding of any kind, whether or not legally enforceable, involving a single transaction or two or more transactions;
“group” has the meaning given by section 357GD of CTA 2010;

"tax advantage" has the meaning given by section 1139 of CTA 2010.

(2) The amendment made by this section has effect in relation to payments made on or after 19 March 2014.