Clause 10 and Schedule 6: Avoidance involving profit fragmentation arrangements

Summary

1. This clause and Schedule introduce a new anti-avoidance rule to ensure that business profits cannot be taken out of the charge to UK tax by arranging for them to be attributed to offshore entities. The new rules have effect for profits arising on or after 6th April 2019 (income tax) or 1st April 2019 (corporation tax).

Details of the clause and Schedule

1. This Clause introduces Schedule 6.

Schedule 6:

2. Paragraph 1 gives an overview of the Schedule and defines the terms "the resident party", "the overseas party", and "a related individual" for the purposes of the Schedule. A "related individual" can be:

   - the resident party,
   - a member of a partnership of which the resident party is a partner, or
   - a participator in a company which is the resident party.

3. Paragraph 2 sets out the arrangements to which the rules apply. Five conditions must be satisfied, set out in paragraph 2(1)(a) to 2(1)(e) inclusive.

4. Paragraph 2(1)(a) requires there to be arrangements ("the material provision") involving the resident party and the overseas party.

5. Paragraph 2(1)(b) requires that "the material provision" gives rise to a transfer of value between the resident party and the overseas party. The typical form of this is for trading receipts to be attributed and paid to the overseas party rather than to a UK-resident person carrying on a business, or for a UK business to pay expenses to the overseas party.

6. Paragraph 2(1)(c) requires that the transfer of value is not in an amount or on terms that would be applied if the transactions were at arm's length.

7. Paragraph 2(1)(d) requires there to be a "tax mismatch". In essence this compares the tax paid in relation to "the material provision" in the jurisdiction relevant to the overseas party with the tax that would have been paid in the UK by the resident party had the transfer of value not been made.

8. Paragraph 2(1)(e) requires that any of the "enjoyment conditions" is met (see paragraph 6).

9. Paragraph 2(2) sets out how the "provision" described in paragraph 2(1) is interpreted where the resident party is a member of a partnership.

10. Paragraph 3 provides further explanation of the term "transfer of value".

11. Paragraph 3(1) provides that the transfer can be direct or indirect.

12. Paragraph 3(2) sets out a non-exhaustive list of circumstances by which the transfer of value could arise.

13. Paragraph 3(3) provides that the transfer can be traced through any chain of entities, however long and complex that chain may be.

14. Paragraph 3(4) sets out that where companies or partnerships are involved, profits, assets and rights must be attributed to the individuals involved in a just and reasonable manner. This will normally be in proportion to their share in a partnership or their rights in a company.

15. Paragraph 4 sets out the "tax mismatch" condition.

16. Paragraph 4(1) sets out that a tax mismatch arises where three conditions are met, and the exemption in paragraph 4(4) does not apply. Firstly, there is an increase in expenses for which the resident party obtains a deduction, or a reduction in the income taken into account by the resident party in computing the amount of tax payable. Secondly, the resulting reduction in UK tax payable by the resident party exceeds the increase in tax payable by the overseas party for the corresponding tax period. Finally, the overseas party does not meet the "80% payment test" (see paragraph 4(5)). For the purposes of this calculation, the starting point is the business profit of the resident party after all other adjustments have been made for tax purposes. This would include adjustments made, for example, under the transfer pricing rules where those rules apply.

17. Paragraph 4(2) defines "the tax reduction" as the amount calculated at paragraph 4(1)(b).

18. Paragraph 4(3) broadens the comparison to encompass both the rate of tax in the overseas jurisdiction and any reliefs or reductions that may apply to the overseas party.

19. Paragraph 4(4) exempts from the tax mismatch calculation any amount that arises solely because of certain types of payment (for example, a payment to a charity).

20. Paragraph 4(5) defines "the 80% payment test" as a comparison between the resulting increase in tax paid by the overseas party (X) and the resulting reduction in the amount paid by the resident party (Y) – as defined at paragraph 4(1)(b). If the value of X is greater than or equal to 80% of the value of Y then the 80% payment test is met by the overseas party. Paragraph 5 provides more detail about the calculation of the amount of tax paid.

21. Paragraph 4(6) provides a rule to compare tax periods where the actual tax periods of the parties do not coincide.

22. Paragraph 4(7) defines a number of terms used in paragraph 4.

23. Paragraph 5 sets out in detail how to carry out the calculation to arrive at the amount of a "tax reduction" for the purposes of the "tax mismatch" described in paragraph 4.

24. Paragraph 5(1) details how to calculate the resulting reduction in tax paid by the resident party. This is done by first calculating a value "A" by adding the lesser of the expenses

mentioned in paragraph 4(1)(a)(i) and the actual deduction allowed at that provision to the amount of the reduction in income mentioned in paragraph 4(1)(a)(ii). The tax rate that would be applicable to the resident party had they had profits chargeable to the relevant tax for that tax period is then applied to A to arrive at the resulting reduction in tax paid by the resident party. Where the resident party is liable to income tax on the business profits, the tax rate to be used is the highest rate of income tax applicable to the resident party for that tax year. For example if an individual is a self-employed trader chargeable at the upper rate of income tax (45%), and they had expenses of £30,000 to which paragraph 4(1)(a)(i) applies, and income of £50,000 to which paragraph 4(1)(a)(ii) applies, the reduction in P's liability to UK income tax would be computed as:

(£30,000+£50,000) × 45% = £80,000 × 45% = £36,000

25. Paragraph 5(2) details how to calculate the resulting increase in tax paid by the overseas party. This is done by considering the increase in the total amount of relevant taxes to be paid by the overseas party assuming that they have income as a result of the material provision of the amount "A", as set out in paragraph 5(1). In considering the total amount of relevant taxes to be paid, the overseas party is assumed to have taken into account any deductions or reliefs in determining their liability to tax as a result of the material provision, apart from any "qualifying deduction" or "qualifying loss relief" (see paragraph 5(8)); and all further reasonable steps are assumed to have been taken to minimise the amount of tax that the overseas party would be required to pay under the law of any country and under any double taxation arrangements.

26. Paragraph 5(3) sets out a non-exhaustive list of what is meant by "further reasonable steps" in paragraph 5(2).

27. Paragraph 5(4) requires that any withholding tax which falls to be paid on payments made to the overseas person or entity be treated as tax which falls to be paid by the overseas person or entity and not the person making the payment – provided the amount is not refunded.

28. Paragraph 5(5) provides further detail about what is meant by an amount of tax payable by the overseas party being refunded. Any repayment made to any person is included if the whole or part of that repayment derives from the tax payable by the overseas party, unless the repayment derives from qualifying losses incurred by the overseas party.

29. Paragraph 5(6) provides an explanation of how paragraph 5 applies in circumstances where the overseas party is a member of a partnership. In these circumstances any reference to the overseas party's liability to any tax includes reference to the liabilities to tax of all members of the partnership; references to any tax being payable by the overseas party include tax being payable by any member of the partnership; and references to loss relief obtained by the overseas party include a reference to loss relief obtained by any member of the partnership. Paragraph 5(4) applies to any member of the partnership as it applies to the overseas party.

30. Paragraph 5(7) sets out the meaning of "qualifying deduction" and "qualifying loss relief". In broad terms, a qualifying deduction is a deduction that would have been given to the resident party in computing its taxable profits had it incurred that amount. Qualifying loss relief similarly means any loss relief that would have been given under UK tax rules to the resident party in computing tax on business profits. For corporation tax this will include all forms of eligible loss relief. For income tax it will include only losses given against business profits, for example losses of a trade carried forward and set against profits of the business in a later

period.

31. Paragraph 6 sets out the "enjoyment" conditions. These conditions consider whether the related individual and/or a person connected with them is able to enjoy the benefit of the amounts that have been transferred to the offshore entity. The arrangements often ensure that the related individual does not have legal entitlement to the amounts, but the practical outcome is that they, their family or other connected persons are able to make use of these amounts, directly or indirectly.

32. Paragraph 6(1) sets out the ways in which a "related individual" (see paragraph 1) may be able to enjoy the amounts arising from the value transferred to the offshore entity.

33. Paragraph 6(2) sets out that the enjoyment conditions can apply irrespective of the nature or form of the benefits, the time at which the benefits may accrue and irrespective of the legal entitlements arising from the arrangements.

34. Paragraph 6(3) extends the enjoyment conditions to cover any person who is connected with the related individual, within the meaning of section 993 of ITA 2007, with certain modifications.

35. Paragraph 6(4) extends the connection test to cover situations where the related individual has effective control or influence over a person's actions even if the individual does not have legal connection with that person.

36. Paragraph 7 sets out how the arrangements are to be counteracted.

37. Paragraph 7(1) requires that in order for the arrangements to be counteracted it must be reasonable to assume that they were entered into to gain a tax advantage. The tax advantage to be counteracted is the advantage arising if this legislation were not taken into account.

38. Paragraph 7(2) sets out the different ways in which a tax advantage may be counteracted.

39. Paragraph 8 provides for a procedure to ensure that the amounts involved are not taxed more than once. The taxpayer may enter a claim and consequential amendments may be made.

40. Paragraph 9 sets out that any payment made by any person to the resident party to enable the latter to meet any tax liability resulting from the counteraction is not to be taken into account in computing the resident party's income or profits for tax purposes.

41. Paragraph 10 sets out the "notification" requirements.

42. Paragraph 10(1) requires that where four of the five conditions in paragraph 2(1) are met the arrangement must be notified. The condition that does not have to be met is in paragraph 2(1)(c), which requires a judgement to be made as to whether the value transferred is not in line with the value deriving from an arm's length arrangement.

43. Paragraph 10(2) sets out the information that must be provided in a notification which includes a description of the "material provision" that should provide some indication as to why the condition in paragraph 2(1)(c) is not met.

44. Paragraph 10(3) sets out that the notification must be made in the tax return.

45. Paragraph 10(4) provides an exemption from the requirement to notify if the value transferred as a result of the material provision is subject to adjustment under the legislation covering

transfer pricing, controlled foreign companies and the diverted profits tax.

46. Paragraph 10(5) provides a power for HMRC to specify other circumstances in which notification is not required.

47. Paragraph 11 sets out how to apply the legislation where any party is carrying on business through a partnership.

48. Paragraph 12 sets out a list of defined terms.

49. Paragraph 13 sets out the commencement rule. The new rules will apply to value transferred as a result of a material provision on or after 1st April 2019 (for corporation tax) or 6th April 2019 (for income tax). The rules apply to amounts arising from arrangements whenever those arrangements were put in place.

Background note

50. This measure tackles tax avoidance arrangements that involve the fragmentation of UK business profits whereby some or all of those profits are said to arise in the hands of an offshore entity in a jurisdiction where there is significantly lower tax than in the UK. Typically the offshore entity is based in a tax haven.

51. The arrangements involve the UK business purporting that business receipts have been earned by the offshore entity, when that entity does not have the substance to earn those profits; or the payment of fees and expenses to the offshore entity that are much higher than is justified by the work done by that entity.

52. The legislation counteracts the arrangements by bringing the relevant amounts back into charge to UK tax, either by disallowing the expenses or by reattributing receipts to the UK business.

53. If you have any questions about this change, or comments on the legislation, please contact Chris Stewart on 03000 519 402 (email: profitfragmentation.mailbox@hmrc.gsi.gov.uk)