

Profit fragmentation – impact on smaller businesses

(Lecture B1152 – 11.21 minutes)

A new provision was introduced as part of Finance Act 2019 that could potentially have a significant impact if HMRC decide to use it aggressively. It is part of a wider clampdown on offshore tax avoidance. The new provisions apply from 1 April 2019 for corporates and 6 April 2019 for individuals.

Many of the provisions already introduced, such as Diverted Profits Tax, have limited impact due to the fact that they have a threshold before they can apply. The profit fragmentation rules do not have such a threshold and are seen as largely being targeted at individuals, partnerships and SMEs. However, there are other pieces of legislation that might also apply and it is important to acknowledge that the profit fragmentation provisions are only relevant if those do not apply.

So you still need to consider if legislation such as the transfer of assets abroad provisions apply. If other legislation only partially corrects a tax mismatch then the profit fragmentation provisions will apply to 'mop up' the unassessed amounts.

These are complex provisions but in broad terms require affected persons to self-assess an additional tax charge where profits are moved out of the UK in circumstances where there is a tax mismatch. This is defined as a situation where the overseas recipient pays tax at less than 80% of the rate that would apply to the UK transferor.

The rules can apply to all UK resident individual, partnerships and companies. It is unlikely to apply to more complex businesses because they will already have to consider transfer pricing (if they are corporates) or other legislation. For example, a large private equity business will be unlikely to be in a situation where profit fragmentation is occurring since they will need to make sure that the disguised investment management fee provisions do not apply to them.

What would trigger a charge under these provisions?

The starting point is that it applies to any transaction or action of any type between an overseas person and a UK resident that leads to value transferring out of the UK. However, there must be a resident party, an overseas party and a related individual. The resident party is the one subject to the legislation and to whom the rules apply. The overseas party is the person to whom the value is transferred and must be resident or established abroad (so a non-UK company which was charged to UK corporation tax as it is centrally controlled and managed in the UK could not be the overseas party). The related individual is the person who can benefit from the value transferred and can be the resident party, a member of partnership of which the resident party is a partner or a participator in a company which is the resident party. The related individual must be an individual who is involved in the business of the resident party.

An example from the HMRC guidance goes as follows:

C Ltd is a UK resident company which trades as a management consultancy firm and which has a 20% shareholder, D. He is responsible for all the company's overseas business and works from the UK but he is the sole shareholder in a BVI company and he agrees that the overseas customers of C Ltd should make payments to the BVI company. C Ltd is the resident company, D is the related individual and the BVI company is the overseas party.

Another example of a situation where this might catch a commercial arrangement would be if a group of partners in a UK partnership set up an overseas partnership with some individuals being partners in both. In this case, the conditions could be met if transactions are not on an arm's length basis.

So whilst the basic premise is incredibly wide, there are specific conditions that need to be met.

Condition 1

There must be an arrangement resulting in a transfer of value that results in profits derived from UK business activities being transferred abroad. The legislation contains a non-exhaustive list of what this means:

- sales, contracts and other transactions made otherwise than for full consideration or for more than full consideration;
- any method by which any property or right, or the control of any property or right, is transferred or transmitted by assigning share capital or other rights in a company, rights in a partnership, or an interest in settled property;
- the creation of an option affecting the disposition of any property or right and the giving of consideration for granting it;
- the creation of a requirement for consent affecting such a disposition and the giving of consideration for granting it;
- the creation of an embargo affecting such a disposition and the giving of consideration for releasing it and
- the disposal of any property or right on the winding up, dissolution or termination of a company, partnership or trust.

Value can be traced through any number of entities to meet the conditions.

Condition 2

The transaction must be otherwise than at arm's length. This is the same principle as applies for transfer pricing purposes although the profit fragmentation rules do not give statutory effect to the OECD transfer pricing guidelines.

Condition 3

It must be reasonable to suppose that the value transferred relates to assets that a relevant individual is entitled to or to an activity undertaken by such an individual.

Condition 4

This condition is that either the enjoyment condition or the procurer condition is met. The enjoyment condition is that it is reasonable to suppose that the individual, or someone connected with them, will have the power to enjoy the transferred profits at some point. Power to enjoy is broadly that the person will get some benefit at some point in the future. The procurer test is met where the related individual procures the transfer of value with the intention of the enjoyment condition being avoided. This latter one might apply in a complex situation where HMRC cannot demonstrate how the relevant individual will benefit but where they are clearly involved in the arrangements.

Condition 5

There has to be a tax mismatch which, as noted above, means that the overseas person or entity receiving the transferred profits will pay less than 80% of the tax that the UK person would have paid.

For corporates, any jurisdiction where the tax rate is less than 15% would need to be investigated. Currently this includes Andorra, Bosnia and Herzegovina, Cyprus, Estonia, Hungary, Moldova, Georgia, Ireland, Bulgaria, Qatar, Uzbekistan, Montenegro and Liechtenstein as well as more traditional tax havens such as the Bahamas, Barbados, Bahrain, Bermuda, BVI, Cayman Islands, the Channel Islands, the Isle of Man, Kuwait, Saudi Arabia and UAE. It would also include any jurisdiction that offers a preferential rate to certain types of business such as the Netherlands which taxes intellectual property profits at 7% or to small businesses (which includes places such as Croatia, Israel, Hong Kong and Singapore).

For individuals who might be paying tax at 45%, the comparative tax rate is 36% and it is hard to think of any jurisdiction that has corporate tax rates as high as that. Of course if transferring profit to another individual, then the rates could be variable and need to be checked.

Condition 6

The main purpose or one of the main purposes of the transfer of value was to obtain a tax advantage. Clearly here you need to be able to argue that the tax saving was not a significant consideration compared with other advantages.

Examples

A UK company offering the consultancy services of its only shareholder establishes a company in a low-cost country to outsource work with that same individual holding all of the shares. Are the conditions met?

Is there a transfer of value? - Any payment for work done will be a transfer of value

Is the transaction otherwise than at arm's length? - This will need to be determined using general principles. Of course, this does take into account the relative value of work done in the different jurisdictions but it is still not a straightforward calculation to do.

Does the value relate to assets that a relevant individual is entitled to? - The UK shareholder has shares in the overseas company so this condition will be met.

Does a relevant individual have the power to enjoy the income? - The UK shareholders will benefit from the income as it can be extracted from the overseas company, so this condition will be met.

Is there a tax mismatch? - This will have to be ascertained but as established above, this condition is met for many jurisdictions.

Is the main purpose to obtain a tax advantage? Here you would need to consider whether the costs saved by outsourcing in this way dwarf the tax saving.

Examples are all from HMRC published guidance

A management consultant is resident in the UK and provides professional services for both UK and overseas customers. A proportion of these services is attributed to the UK business, with those receipts reported by the UK business and taxed in the UK. However, the remaining receipts are paid by customers directly to an offshore company in a tax haven, owned by a trust based in the tax haven. These are paid in return for consultancy services allegedly provided by the offshore company, which has no assets apart from access to the skills and services of the management consultant himself, neither of which is exercised to any material extent in the tax haven. The management consultant in the UK is expressly excluded from benefiting from the trust but relatives can benefit. The underlying reality is that all income derives from a single underlying activity (namely the skills of the consultant, who is a UK resident), that no or negligible services are performed by that person in the low tax jurisdiction itself, and consequently the full profits should be taxed in the UK as profits of the consultant.

J, a UK resident and domiciled individual, owns all of the share capital in a UK resident company which makes a payment of £150,000 to an overseas company. The overseas company is owned by an overseas trust of which J is both the settlor and beneficiary. Following enquiries, it transpires that the payment is made for services provided by the overseas company though the payments being made are inflated. The value of the services if they had been undertaken at arm's length are £100,000 not £150,000 though full amount of this receipt is treated as income in the overseas company's accounts. It is assumed for the purpose of this example that no other legislation applies. The conditions for both the transfer of assets abroad regime and the profit fragmentation regime apply. The TOAA regime will tax the full amount of income under s720 ITA2007 so the profit fragmentation provisions will not apply.

In 2016 Company A, a UK resident research and development company, ('A Ltd') created a new type of high-tech micro-chip used in mobile phones. The technology was ahead of its time on creation and the company did not anticipate that it would need any technological maintenance for at least 4 years. In 2018 the patent for the micro-chip was transferred to Company B ('B Ltd'). B Ltd is another group company, based in the British Virgin Islands (BVI), which holds all of the group's patents and exploits them all over the world. This transfer took place on arm's length terms: B Ltd paid a significant sum to A Ltd. in return for the patent.

B Ltd. has a workforce based in the BVI responsible for exploiting the group's patents to customers. During the accounting period ending 31 December 2019 B Ltd. generated income of \$1m from its customers relating to the patent. The Profit Fragmentation legislation will not apply to the transfer of the patent in 2016 because the transfer took place in advance of the legislation applying. Furthermore, it will not apply to the income generated by B Ltd during the APE 31 December 2019 as this income is not properly attributable to the UK business.

However, let us consider the situation where the micro-chips need updating to ensure the technology remains current. B Ltd. does not have the necessary expertise to update them, so A Ltd. updates the technology for B Ltd. but does not receive any remuneration for doing this. The service of updating the technology by A Ltd without receiving any remuneration results in a transfer of value to B Ltd. The Profit Fragmentation legislation could apply to this transfer of value at the time this occurs (in this example this is during the accounting period ended 31 December 2020) provided the arrangements are Profit Fragmentation Arrangements and the exception conditions don't apply.

Practical advice

So what practical advice would you give to SMEs to protect them from being caught out by these rules?

Review current transactions and structures to see if a tax mismatch arises, which would potentially lead to the increase in the foreign tax being less than 80% of the reduction in the UK taxation as a result of the transaction.

Where a mismatch arises, consider whether the 'enjoyment' condition is satisfied so that a UK relevant person can benefit from the profits that are not taxed in the UK.

If both of the above conditions are met, consider whether the transaction is at arm's length and therefore not excessive when compared to the activities being undertaken.

It is then recommended that the company considers and evidences, as appropriate, why the main purposes, or one of the main purposes, of the transaction was not to obtain a tax advantage and, therefore, why the company believes that the anti-fragmentation provisions do not apply.

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