MOORE Kingston Smith

PROFIT FRAGMENTATION RULES

The 'profit fragmentation rules' aim to tax profits which have been moved from UK individuals, partners or companies to offshore entities. The rules apply for transactions on or after 1 April 2019 (companies) or from 6 April 2019 (individuals).

Who do the rules apply to?

The rules apply to all UK resident individuals, partners in partnerships and companies. In practice, we would expect that they will most commonly affect small or medium-sized enterprises (SMEs) which are not within the transfer pricing legislation, and individuals, with offshore activities. SMEs are exempt from the UK transfer pricing regime where the other party is in a qualifying treaty territory and the UK entity has fewer than 250 employees, and either turnover of less than €50m or a balance sheet total of less than €43m.

Since large organisations already comply with the transfer pricing regime and the diverted profits rules, it would be unlikely that they would be subject to any adjustment under the profit fragmentation rules. However there may be exceptions to this and all entities are obliged to self-assess whether the rules apply or not.

What situations do the rules apply to?

The rules apply to arrangements where the following conditions are met:

Transfer of value

There must be a transfer of value from the UK resident to an overseas resident person that is of a greater than arm's length value.

The meaning of a transfer of value is very broad and will catch any transfer of property, income or other rights, by whatever means, with any measure of increase or reduction in value.

Tax advantage or tax mismatch

The arrangements are motivated either by a tax advantage, or there is a 'tax mismatch' resulting from the arrangements between the UK and overseas persons.

It is important to note that even though HMRC has stated that these rules are intended as targeted anti-avoidance rules, there is no specific compulsory tax avoidance 'motive' test. They may apply regardless of motive where there is a 'tax mismatch' between the two parties.

A 'tax mismatch' exists where the amount of UK tax paid as a result of the arrangements is reduced, but the corresponding increase in overseas tax is less than 80% of the reduction.

This would affect for instance UK companies with other group companies in jurisdictions with a tax rate of 15% or lower based on the corporation tax rate applicable until 31 March 2020, or 13% or lower from 1 April 2020 thereafter.

Where overseas entities benefit from local tax reliefs (such as for research and development), the profit fragmentation rules should be considered closely to determine whether the relief forms part of the comparable amount of overseas tax paid for the purpose of the tax mismatch test.

Where the UK person is an individual transacting with an overseas company, the potential scope is wider under the tax mismatch test, due to the higher applicable UK income tax rates.

Enjoyment of benefit

The UK resident person, or connected parties, can enjoy, directly or indirectly, the economic benefit of the value transferred.

What effect do the rules have?

Where the rules apply based on the conditions outlined above, the rules will bring the amounts into charge to UK tax. Depending on the type of transactions involved, this will be achieved either by disallowing expenses or reattributing receipts to the UK business.

How can Moore Kingston Smith help?

These rules are widely drafted and may apply to circumstances which you may not expect. HMRC has increasingly focussed on taxpayers with overseas interests and now has wide ranging powers to obtain information on them.

We will analyse your business structure and transactions to consider whether the rules apply. Our analysis can form support for your and/or your company's self-assessment. Where any transactions are identified which may potentially be within the rules we can also complete a transfer pricing benchmarking exercise to ascertain whether the transactions were carried out at arm's length.

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We can advise on carrying out potential restructuring of your business where an adjustment may otherwise be required.

Please contact us if you would like further advice on the profit fragmentation rules.