Avoidance involving profit fragmentation: Clause 16

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Legislation introducing an anti-profit fragmentation rule incorporates a number of improvements on the previous draft legislation and original consultation proposals.

Clause 16 and Schedule 4 of the Finance Bill introduces new anti-avoidance rules from April 2019 to tackle profit splitting arrangements entered into by individuals, partnerships or companies that aim to move profits out of the charge to UK tax by arranging for them to be attributed to offshore persons or entities.

Very broadly, arrangements are *profit splitting* arrangements, and subject to counteraction, if all of the following apply:

- There is a transfer of value derived from a UK trade to an offshore entity.
- The transfer results in a tax mismatch – broadly the extra tax payable overseas is less than 80% of the reduction in UK tax.
- A UK related individual (for example, a sole trader, shareholder, partner) has arranged for the profits to be diverted and can continue to 'enjoy' them (widely defined).
- The profit allocated to the offshore entity is excessive having regard to its activities.

These rules were the subject of a previous HMRC consultation and draft legislation was released in July 2018.

It is reassuring to see that some of the concerns expressed by the ATT and other professional bodies during the earlier consultation phases have been addressed in the final legislation. In particular:

- The requirement for taxpayers to notify HMRC of schemes has been dropped. The draft legislation proposed a wide test for notification, which could have resulted in a requirement to notify even where no tax was due. Proposals to also require advance payment of any tax due were dropped after the initial consultation.
- A clear *motive* test has been incorporated into Schedule 4 paragraph 2(2)(b) which states that arrangements are not profit fragmentation arrangements if it is not reasonable to conclude that the main purpose, or one of the main purposes, for which they were entered into was to obtain a tax advantage.
- When discussing the tax mismatch, Schedule 4 paragraph 5(1)(b) requires it to be ‘reasonable to conclude’ that the reduction in the tax in the resident party exceeds the increase in the overseas party and that the 80% test is not met. HMRC have confirmed that this is to reflect the fact that the exact tax position of the overseas party may not always be known.
- There is further clarity over which party’s position is to be considered when making any counteraction.

Overall these changes, together with some alterations to the layout and wording of the legislation, should make it easier for both taxpayers and advisers to follow and apply it in practice. In particular, the introduction of a clear motive test and removal of any notification or pre-payment requirement should reduce the number of taxpayers who are practically affected by the rules.