

Tax compliance for multinationals: a new dilemma

Overview

HMRC has launched its new 'Profit Diversion Compliance Facility' (PDCF). The facility is designed to encourage multinational enterprises (MNEs) with arrangements that might fall within the scope of the Diverted Profits Tax (DPT) to review both the design and implementation of their historical transfer pricing policies. Where such a review suggests additional UK corporation tax is due, MNEs can use the PDCF to submit a detailed Report and Proposal for any such additional tax and interest (and where applicable, penalties). The PDCF guidance is available [here](#).

HMRC's position on transfer pricing has shifted significantly over the past 5 years with the BEPS Actions 8-10 changes to the OECD Transfer Pricing Guidelines and the introduction of DPT. Combined with greater powers to request information from taxpayers and increased resources to carry out detailed investigations, we are increasingly seeing MNEs reach higher settlements with HMRC in order to put an end to lengthy and expensive investigations. The PDCF offers a potential opportunity for MNEs to bring their transfer pricing in line with HMRC's expectations without the burden of an HMRC led investigation.

How will the PDCF work?

MNEs that register for the facility will have 6 months (or longer if agreed by HMRC) to undertake an internal investigation proportionate with the tax at stake and the complexity of their business, and to provide full and accurate disclosure of any potential corporation tax and DPT liabilities for all years open to enquiry in the form of a Report (along with full payment of the proposed settlement amount).

The facility is only open to MNEs that register before HMRC commences an investigation into potential profit diversion. Groups that are already in a UK diverted profits or transfer pricing enquiry are precluded from using the facility and will need to continue to seek resolution of their affairs through the normal enquiry route.

HMRC has indicated that it will be sending letters to some MNEs assessed as at high risk of profit diversion which will suggest that those businesses consider use of the facility. Groups that receive a letter and register for the facility will still be able to benefit from unprompted penalty treatment that reduces penalties in respect of careless inaccuracies in returns (potentially to nil) for timely and accurate disclosure.

Groups that receive a letter and do not register will likely be subject to an HMRC investigation. We understand from HMRC that such investigations are likely to be led by HMRC's Fraud Investigation Service (FIS). HMRC has not committed to sending letters to all MNEs identified as high risk and may instead launch an investigation without prior warning. Therefore, Groups should not wait to hear from HMRC before considering whether to use the PDCF.

Once a registration has been submitted, HMRC will defer investigation into potential corporation tax, DPT or other liabilities arising from the arrangements until the Report is due to be submitted. HMRC is prepared to meet with groups who register for the facility to discuss the proposed approach for the internal investigation and preparation of the Report (the Registration meeting) and prior to the submission of the Report (the Pre-Submission meeting) to explain the work that has been undertaken, the conclusions reached and the Proposal.

The PDCF provides detailed guidance on how the Report should be prepared, essentially entailing a full internal investigation by the Group in a manner similar to that which HMRC would normally follow during an enquiry. The Group will need to consider relevant documentation, interview appropriate employees and test the facts through review of employee emails. The evidence reviewed should be logged in the Report but does not need to be provided to HMRC. The Report itself will need to set out a detailed examination of the facts and an analysis of the application and interpretation of those facts from a transfer pricing perspective,

along with the behaviours relevant to assessing whether penalties might be due for careless or deliberate behaviour or failure to notify. The Report does not need to provide a technical analysis of the application of the DPT rules.

HMRC is aiming to consider Reports and Proposals within three months of submission through a specific governance framework established for the PDCF. HMRC expects to be able to accept most Proposals that take account of the guidance and reflect the principles in it without any further enquiry or review of the underlying evidence. Where a Proposal is accepted it will be implemented through the taxpayer amending its self-assessment corporation tax returns and/or HMRC issuing enquiry closure notices and discovery assessments as necessary. The PDCF guidance also states that HMRC will commit to not issuing DPT preliminary notices.

The PDCF confirms that a formal Advance Pricing Agreement remains the only way to achieve certainty in relation to future years. However, the facility also provides that where there has been no significant change in circumstances or conditions, a return made on the basis agreed under the Proposal is likely to be looked upon as presenting a low tax risk. Applications can continue to be made for a Mutual Agreement Procedure claim through the normal procedures.

In some cases, HMRC may ask to review evidence gathered in preparing the Report before accepting the Proposal. Where a Proposal is not accepted, HMRC expects that the work undertaken in preparing the Report should provide a good basis for quick and efficient resolution of any differing views between HMRC and the taxpayer. Where a Proposal is not accepted because the Report contains deliberate errors, the PDCF guidance confirms that there will be no immunity from criminal investigation.

Registering and submitting a Report under the facility does not require a group to accept that their arrangements fall within the scope of DPT and the PDCF guidance confirms that HMRC will not regard the making of a Proposal as indicating that the MNE considers DPT could or should apply. The analysis of the application of the law to the facts included in the Report can also be provided on a without prejudice basis.

What should MNEs do next?

Where a business receives a letter from HMRC it will be important to give thorough consideration to whether or not to register for the PDCF, especially in light of the likelihood of a FIS-led investigation where a decision is taken not to register. Even if a decision is taken not to register, the analysis undertaken in making that decision will be useful as a 'defence file' for the purposes of future discussions with HMRC.

Even if a business does not receive a letter from HMRC, this provides no comfort that the business will not ultimately be investigated. Businesses that have not been subject to a recent transfer pricing or diverted profits investigation, but are presenting with any of the risk indicators of profit diversion (see below), should be analysing whether the PDCF provides an opportunity to bring their UK tax affairs up to date.

Potential benefits of registering for the PDCF include:

- **Internally led investigation.** Our recent experience of HMRC investigations is that they can be extremely lengthy and resource-intensive, requiring taxpayers to respond to unreasonably broad information requests and lines of enquiry that have little or no effect on the transfer pricing outcome. The ability to shape and control the investigation should ensure a more focused and efficient process to reach a robust outcome at a significantly lower cost and time burden.
- **Accelerated resolution.** HMRC is aiming to respond to PDCF Proposals within three months. We understand that there will be a PDCF specific governance process with a view to providing accelerated resolution for MNEs that register. Where a Proposal is not accepted, the work that has been undertaken by the group should allow for a swifter resolution of any remaining areas of disagreement.
- **Potential penalty protection.** The PDCF does not provide any special penalty protection. However, where a group receives a letter from HMRC and registers for the facility, it will still be able to benefit from unprompted penalty treatment which can reduce penalties in respect of careless inaccuracies to zero. By contrast, MNEs that wait for HMRC to launch an investigation will potentially be liable for tax-gear penalties at a minimum of 30% of the additional tax payable in respect of careless inaccuracies. The PDCF guidance states that inaccuracies in returns filed after 31 December 2016, arising as a result of a failure to take into account the BEPS Actions 8-10 Report, will be treated as careless. Accordingly, in order to take advantage of the reduction of penalties for timely disclosure, the Report needs to be submitted within three years, i.e. **by 31 December 2019**. This position reflects

HMRC's view that the BEPS Actions 8-10 Report only clarified the existing OECD Transfer Pricing Guidelines and did not change them. In our view, it is arguable that returns for periods starting on or before 31 March 2016 were not legally required to take account of the updated OECD Transfer Pricing Guidelines. This is an issue that may require further analysis for Reports submitted after the 31 December 2019 deadline.

- **DPT failure to notify penalties.** HMRC's updated DPT Guidance (published in December 2018) provides that where a taxpayer has non-deliberately failed to notify for DPT, the DPT will be treated as having first become unpaid on 1 January 2019. This is an extension of the strict time limit under the DPT legislation and applies to all taxpayers whether or not they register under the PDCF. If HMRC becomes aware of the failure to notify within 12 months of the date the DPT is first treated as having become unpaid, it is possible that the penalties can be reduced to zero. This creates an incentive to disclose any potential failure to notify for DPT within 12 months of 1 January 2019, i.e. **by 31 December 2019**. Voluntarily registering for the PDCF, rather than waiting for an HMRC investigation, would ensure that the MNE can benefit from the penalty reduction.

These potential benefits will need to be weighed against the challenges of registering for the PDCF which will include committing to ensure that the Report provides full and accurate disclosure and is produced within the timeframe agreed with HMRC. Further, the taxpayer will bear the risk related to the uncertainty of how the facility will operate in practice, which will not become clear until the first Reports have been submitted through the governance process.

HMRC's approach to profit diversion

The PDCF guidance and HMRC's updated DPT Guidance provide useful insights into HMRC's approach to diverted profits and transfer pricing enquiries more generally. HMRC notes that it is finding that in a high proportion of diverted profits investigations the arrangements do not stand up to scrutiny and that significant additional tax is due. It considers this to be for two main reasons:

- existing transfer pricing policies are based on incorrect assumptions or are incorrectly implemented, and the facts on which the transfer pricing analysis is based diverge from what is happening on the ground in the business; and/or
- transfer pricing policies do not accord with the OECD TPG as updated by the BEPS Actions 8-10 Report, for example due to an over-reliance on contractual assumption of risk and legal ownership of assets, or reliance on inappropriate comparables.

The PDCF guidance provides a list of general risk indicators, which in our experience have been the key battleground in transfer pricing enquiries over the past few years. Summarised at a high level, these include:

- narrow interpretations of the DPT charging conditions;
- contractual allocations of risk that do not align with the functions controlling those risks;
- regional sales roles and key account management in the UK that are under rewarded by the existing transfer pricing policies;
- centralised procurement functions in low tax jurisdictions receiving payments from UK entities;
- contract R&D functions in the UK that seek the benefit of tax reliefs (R&D credits, patent box) that are also treated as low value-adding functions for transfer pricing purposes; and
- legal owners of IP based in low-tax jurisdictions receiving residual profits with insufficient substance and subcontracting of relevant activities to UK services providers.

Groups with transfer pricing arrangements that potentially fall within any of these risk indicators should consider analysing their existing transfer pricing arrangements in deciding whether the facility could be of relevance to them.

How we can help

Our team of lawyers, litigators, economists and tax advisers have assisted a large number of MNEs to reach settlements with HMRC. Our experience of HMRC's approach to diverted profits and transfer pricing

enquiries means that we understand the level of factual and technical diligence required to develop a settlement proposal that will be accepted through HMRC's governance processes.

Transfer pricing expertise. We have the experience and the expertise to advise groups at all stages of utilising this facility: from performing an initial risk assessment of the group's affairs to developing a Proposal for submission to HMRC, through to responding to and negotiating HMRC counter-proposals. Baker McKenzie also has significant experience of codifying the outcome of HMRC enquiries in advance pricing agreements that provide certainty for future years.

Large-scale investigations capabilities. Our experience and capabilities in investigations and white-collar crime allows us to plan, manage and conclude large-scale corporate investigations projects. This experience enables us to harvest vast quantities of data (e.g. through employee interviews, email reviews and file searches) in an efficient yet thorough manner. A key element of this process is managing and protecting legally privileged information.

Technical positions. We are able to provide legally privileged advice on the merits of the technical analysis that can form the basis of the analysis of the application of the law to the facts in the Report. Documenting settlement. Whether settlement with HMRC is to be reflected through existing statutory mechanisms (e.g. tax return amendments, discovery assessment and closure notices) or through other means (e.g. contractual agreements and deeds of settlement), it is critical that such documentation is complete and accurate in order to protect a group's position. We have considerable experience of negotiating such documentation while also being able to take a pragmatic view as to what HMRC are likely to accept.

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