

## The profit diversion compliance facility: a welcome opportunity or a trap to be avoided?

January 2019

HMRC announced details of the new diverted profit tax/transfer pricing disclosure facility on 10<sup>th</sup> January. While some may be concerned about “putting their heads above the parapet” or spending time and money to give HMRC a much more detailed and supported transfer pricing report *only* for it to be rejected, the indications are that HMRC want to make the facility work and to give taxpayers the opportunity to take control over the way supporting TP information is gathered. Many will welcome this initiative as a potential way of getting a TP resolution or certainty, doing so more quickly and easily by controlling the initial process and dealing with a more senior and experienced HMRC team.

There are those who see diverted profits tax (“DPT”) as unjustified extra-territorial taxation or as a solution to the digital trading problem (in either case justifying the title “Google tax”) and object to it fundamentally. That view is particularly prevalent in the US - but it is wrong, of course.

There are others who see DPT as a more rigorous form of transfer pricing with greater disclosure, and a requirement to put UK profitability into a global context so as to produce a “more accurate” assessment of the UK contribution to the group or global profitability - therefore, as transfer pricing with “added brutality” (in the form of the requirement to pay tax upfront, the higher rate

etc) in order to ensure that a proper discussion and assessment takes place.

It would be interesting to see full and detailed statistics, but many practitioners engaged in this area are likely to agree with HMRC’s own assessment that most enquiries can be, and are being, resolved under the transfer pricing code with tax payable only at the CT rate, and that DPT liabilities are only likely to arise:

- in cases where HMRC are challenging and seeking to recharacterise the transaction actually entered into on the basis that it is artificial in nature; or
- in situations where the taxpayer concerned is, in HMRC’s eyes at least, resisting open and transparent negotiations - though there have been cases where failures of communications have occurred and preliminary notices have been issued to undeserving taxpayers.

That does not, of course, generally mean that DPT enquiries do not, from every affected taxpayer’s point of view, fall into the “great big nuisance” category. They are expensive (both internal and external costs) and time consuming (two to three years not being at all unusual) and will often produce allegations that HMRC are wasting time by going up blind alleys.

Recent budget changes have recognised the time involved in doing the job properly here - and implicitly supported those who think that transfer pricing reports in their historic form are nowhere near as thorough in terms of analysing business functions, assets and risks as a full HMRC investigation (with extensive interview and maybe executive email searches) can be and often is.

### Experience of DPT

Many who have engaged in DPT enquiries have (quite rightly) complained about the inexperience of some case teams, the inconsistency of approach

(on things like interviews and emails searches and overall the manner in which individual enquiries have been carried out). Some of those grumbles are likely to be true, but HMRC has devoted a lot of new resource to this area, which has needed training up of staff, and has put a lot of effort into making sure that the picture is the same across the waterfront. Efficiency and consistency are both clearly important. Subject to staff movements and losses, HMRC is getting better all the time and, as an organisation as a whole, it is likely to have a better picture of the cross-border activities of MNCs within the scope of the UK transfer pricing rules than many of their overseas counterparts will have.

On the taxpayer side, we have already had experience of people who have been given their opportunity to put their heads above the parapets and confess they *might* have a DPT exposure by notifying that to HMRC and getting the “benefit” of the two year time limitation for HMRC to take action for any period. Some who saw that as a way of putting pressure on HMRC to “put up or shut up” within a relatively limited time frame may have had cause to regret that as the lack of time available to do a full investigation and go through HMRC governance processes can mean that the case ends up in preliminary notice territory with only a short period (recently extended) to complete enquiries and reach the magic ground of resolution.

Those who have decided to take the risk on penalties, and so face a *slightly* more leisurely four year period may equally have had cause to celebrate that but 2019 will test whether or not a four year period is enough for some complex enquiries.

For all though, the uncertainties remain as to:

- whether a particular MNC is going to be investigated under DPT; and

- whether any investigation will follow what the particular MNC sees to be a sensible path in its particular circumstances.

### The new facility

Now, the Profit Diversion Compliance Facility (PDCF) gives taxpayers who “have cause to be concerned” an opportunity to take control (for a time at least) of their own enquiry.

The PDCF announced on 10<sup>th</sup> January confirms HMRC’s intention to work DPT cases openly and collaboratively. The more taxpayers are seen to be cooperative in reaching resolution, the more they will be able to persuade HMRC to conduct the enquiry in a preferred and mutually agreed way. Control (to the extent that either side truly has that) is generally only lost in cases where there is a lack of openness and trust.

What the PDCF enables taxpayers to do is tell HMRC that it is conducting its own investigation with a view to producing a report (which will probably be similar in form and content to the DPT or TP reports that HMRC itself puts through its own governance processes) that will support either the current or an amended transfer pricing position.

To the extent that the transfer pricing position of the MNC concern has to be amended, then it will have to pay additional taxes and interest plus possibly penalties (which will be treated as mitigated by the submission of the report) at the time of submission.

As HMRC’s note says, this report will:

- enable MNCs to bring their tax affairs up to date openly, efficiently and without investigation by HMRC if a full and accurate disclosure is made;
- give them certainty for the past and a low risk outcome for profit diversion in the future;

- provide an accelerated process - HMRC will aim to respond to the proposal within three months of submission;
- allow the MNC to manage its own internal processes around what evidence to gather, who is interviewed, what comparables are used (if any), and how the analysis is presented; and
- give unprompted penalty treatment if HMRC has not already started an investigation into profit diversion.

So, what could anyone possibly object to about that?

Well, some commentators may ask why anyone would apparently want to put their heads on the chopping block in this way. Wouldn't the best tactic be to keep your head out of the way and hope you escape scrutiny?

The answer to that is that no-one in the frame should expect to escape scrutiny.

## Why use the PDCF?

The key benefits then for those who are considering using the PDCF (which many are likely to do) is "control" of the way in which the investigation is (initially at least) carried on, and the shortness (three months) of HMRC's committed response time (with a "specifically designated, experienced team of specialists" looking at the reports when they are submitted on a priority basis).

So MNCs should decide:-

- 1) whether they are bound to be in the frame for an eventual DPT enquiry;
- 2) whether they have the resources to be able to do their own investigation and the experience/knowledge to submit that in a way which is either likely to be accepted

immediately or form the basis for a shorter enquiry process later; and

- 3) whether submitting this return could have any knock on consequences in relation to other tax matters in the group concerned.

The upside is the ability to control the early agenda and initial scrutiny by an experienced specialist team - and the downside is whether or not an MNC might end up giving HMRC more information than would have emerged through a normal enquiry process (which seems unlikely given the current climate though).

If, after taking all these matters into account and accepting that HMRC are likely to want to make this process work for a whole host of reasons but not least the management of its own workload, an MNC decides to go ahead, then more specifics are contained in HMRC's note. However the report should:-

- be submitted within six months of the process starting (which is quite a tight period)
- cover all open periods
- cover all relevant group matters

One of the big advantages of this process is that there is the ability to pre-submit the report for HMRC commentary and to have discussions with HMRC through the process.

The rest of HMRC's note then contains some useful guidance on its current approach and attitude to cases potentially within the scope of DPT.

## Final thoughts

Take up of the PDCF is likely to depend in large part on two key behavioural elements, one on the part of HMRC and one on the part of taxpayers (and their advisers).

Unless and until HMRC have been seen accepting reports and that the PDCF has delivered the anticipated benefits to the first few MNCs to take it up, there is likely to be a natural reticence for groups to commit to this process. Initially at least, you can see heads of tax having to work quite hard to convince their CFOs it is a sensible course of action. So that requires responsible behaviour on the part of HMRC.

The PDCF is quickly going to lie unused if it develops a reputation for simply accelerating a full scale enquiry of the past - but it is not in HMRC's interests for that to be the case.

That is also though where taxpayers and advisers have a role to play too. HMRC will have no option but to reject a report which falls short on required substance and so unless the first few reports to go in are prepared properly and in good faith, there is a real risk that PDCF never really gets off the ground. But if they are, it could become a very useful tool for taxpayers to bring their affairs up to date in an efficient (in both time and cost terms) manner.

Overall, this is an encouraging development.

*This article was first published in the 18 January 2019 edition of Tax Journal.*



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