

# Transfer window

International Tax

Large Corporate



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*Peter Steeds* and *Paul Fields* look at trends in HMRC's post-BEPS approach to transfer pricing

## Key Points

### What is the issue?

Following the publication by the OECD of the final Base Erosion and Profit Shifting (BEPS) papers in October 2015, HMRC has revisited its approach to transfer pricing, and with the introduction of an onerous anti-avoidance regime in Diverted Profits Tax (DPT), many multinationals have found themselves under increased scrutiny.

## **What does it mean to me?**

The first quantitative evidence of the outcome of this scrutiny was seen in HMRC's publication on 13 September 2017, after a gap of three years, of its *Transfer Pricing and Diverted Profits Tax Statistics*, to 2016/17. It showed a 90% year-on-year increase in corporation tax from transfer pricing adjustments to more than £1.6 billion, and a further £281 million attributable to DPT.

## **What can I take away?**

So even if the behavioural changes referred to in the statistics reduce the risk of transfer pricing adjustments and DPT charges for some taxpayers, we expect HMRC will continue to focus a significant proportion of its resources on cross-border transactions for the foreseeable future. Multinational taxpayers ignore this new reality at their peril.

Last year, our *Tax Adviser* article on developments in transfer pricing dispute resolution ('New remedies', April 2017) highlighted the importance of the steps being taken internationally to improve dispute resolution mechanisms. The expected major increase in transfer pricing disputes needed a counter-balance for taxpayers, and subsequent months have shown plenty of evidence of this increase.

Following the publication by the OECD of the final Base Erosion and Profit Shifting (BEPS) papers in October 2015, HMRC has revisited its approach to transfer pricing, and with the introduction of an onerous anti-avoidance regime in Diverted Profits Tax (DPT), many multinationals have found themselves under increased scrutiny. The first quantitative evidence of the outcome of this scrutiny was seen in HMRC's publication on 13 September 2017, after a gap of three years, of its *Transfer Pricing and Diverted Profits Tax Statistics*, to 2016/17 which opened a window on the scale of the issue. It showed a 90% year-on-year increase in corporation tax from transfer pricing adjustments to more than £1.6 billion, and a further £281 million attributable to DPT.

## Transfer pricing

The BEPS Actions 8-10 (*Aligning Transfer Pricing Outcomes with Value Creation*) report fundamentally revised the rules to align value creation with substance. In doing so, it provided expanded guidance on treatment of intangibles, the control of risks and other 'high risk' areas of transfer pricing. These changes are now incorporated into the 2017 OECD Transfer Pricing Guidelines and reflect the international consensus on how complex intragroup transactions should be priced. However, they are arguably more subjective than before and are open to differing interpretations by different tax authorities and taxpayers. The resulting increase in disputes appears inevitable in such circumstances.

The statistics show, as well as the huge increase in yield, the ongoing administrative burden of enquiries, with the average time to reach settlement now comfortably in excess of two years. HMRC also notes the interaction between DPT and transfer pricing, with many adjustments resulting from enquiries also covering DPT. Unsurprisingly, many taxpayers will have negotiated a corporation tax settlement through agreement on transfer pricing rather than the 'pay first argue later' DPT regime and a penal rate of 25%.

The statistics are no surprise to practitioners. There has been a noticeable increase in HMRC audit activity under the umbrella of HMRC's Large Business Diverted Profits Project with enquiries often extending to multiple issues including transfer pricing, DPT, permanent establishments and withholding tax. These enquiries have most recently been driven at a faster pace in order to reach conclusion before the expiry of DPT preliminary notice time limits (see below). They have also included more invasive information gathering techniques, such as seeking to interview large numbers of commercial staff, inside and outside the UK, requesting access to company emails, and in some cases wanting to speak directly to taxpayers' customers. Such an approach is exceptionally resource intensive for the taxpayer.

Whilst previous spikes in yield have been driven by the resolution of a small number of large cases, our expectation is that this is not the reason this year, and this level of tax take is likely to continue. Given the BEPS developments, the introduction of DPT and other domestic regime changes, and the continuing media profile of the tax affairs of multinationals, we believe HMRC will continue to commit significant compliance resource to this area.

## **Advance Pricing Agreements**

The statistics on Advance Pricing Agreements (APAs) show a drop in the number of applications made, along with an increase in the number turned down by HMRC. This is also unsurprising, given that HMRC has raised the bar for entry into the programme following the publication of a revised Statement of Practice 1/2012 in November 2016. The move away from unilateral APAs, a focus on those transactions that are likely to result in double taxation absent an APA, and the requirement for a DPT review to accompany all applications, have all contributed to these changes.

Despite these statistics, the APA programme still offers taxpayers an opportunity to obtain certainty over their transfer pricing in uncertain times, and HMRC continues to accept the majority of bilateral applications.

## **Advance Thin Capitalisation Agreements**

The number of Advance Thin Capitalisation Agreements (ATCAs) agreed in the year has continued to decline. As expected, the introduction of the Corporate Interest Restriction (CIR) rules has had an effect on the number of ATCAs sought, as the new legislation takes a more prescriptive approach. However, it is important that taxpayers appreciate that the CIR rules apply only after the arm's length test has been met. Therefore, there remains a great deal of value to be obtained by taxpayers seeking certainty over the arm's length nature of their interest deduction, and HMRC have indicated they are happy to consider applications. We believe that the reduction in ATCAs is likely to be a reset to a new lower number agreed each year.

## **Mutual Agreement Procedures**

A major issue for taxpayers suffering transfer pricing adjustments is the prospect of double taxation. The UK has a large tax treaty network which allows the taxpayers to apply for a Mutual Agreement Procedure (MAP) to gain relief from double taxation. BEPS Action 14 focused specifically on effective dispute resolutions, as has a new EU Directive (although the latter is unlikely to benefit UK taxpayers, post-Brexit). The improving opportunities for taxpayers to access binding arbitration to resolve disputes through bilateral treaties, the OECD's Multilateral Instrument or the European Arbitration Convention is welcome and should encourage more widespread use of these mechanisms.

As expected following the report on the UK MAP process peer review published by the OECD last September, HMRC has updated its MAP guidance (INTM 423000). HMRC's track record in MAP to-date is encouraging, with an average resolution time of approximately two years. But with the number of cases admitted into MAP at an all-time high, and differences of opinion between jurisdictions on transfer pricing matters post-BEPS already becoming apparent, the OECD notes that the UK will have to continue to ensure it provides adequate resources for addressing MAP claims.

## **Diverted Profits Tax**

Whilst DPT has been in force since 1 April 2015, HMRC has had two years from the end of a company's accounting period to raise a preliminary notice if the taxpayer has made a notification that the legislation may apply to them. Therefore it is only in the last year that we have really seen taxpayers beginning to be issued with charging notices.

The DPT statistics show a total yield in 2016/17 of £281m, composed of DPT charging notices (£138m) and the remainder from what HMRC deems to be 'behavioural change' entailing taxpayers altering their transfer pricing arrangements, with or without HMRC intervention. These numbers exceed the original Treasury forecasts, and in conjunction with the £1.6bn corporation tax yield show the 'game changer' effect that HMRC officials say that DPT has had.

Many taxpayers with December year ends will have seen their first preliminary notices (and charges) in late 2017, and we therefore expect another major jump in the DPT yield in next year's statistics.

DPT enquiries have also been wider spread than originally expected, and have proved extremely difficult to manage, with major uncertainties about its application remaining, two years into the regime.

## **The future**

We expect to see a continuing increase in the number of transfer pricing and DPT enquiries, often running in parallel, as well as in the yield from both. This will be fuelled further as larger taxpayers begin to file their Country-by-Country reports, giving HMRC, and other tax authorities, an unprecedented level of insight into a

taxpayer's operations and tax profile. This underlines the importance of taxpayers exercising best practice and preparing contemporaneous transfer pricing documentation in line with the BEPS Action 13 report, to give tax authorities the proper context and understanding of their global value chains, whilst also protecting themselves from potential tax-gear penalties.

One common theme across the statistics is that there is a general increase in the time that it takes to settle enquiries. This is a trend that we would expect to continue as the number of enquiries and assessments increases, and HMRC's rigorous internal governance process lengthens the process further. That said, we may see a dip in timeframes in 2017/18, as a result of the time pressures imposed on business by HMRC because of the DPT preliminary notice deadlines.

Whilst multinationals can expect to continue to have their tax affairs closely examined by HMRC, HMRC's updated MAP guidance and the global initiatives on dispute resolution should enable the elimination of double taxation in a more timely and cost-effective manner than before.

## **Conclusion**

Some multinationals have responded to the BEPS changes by changing their structures, operating models and transfer pricing to mitigate tax risks. However, to date, the majority have not. Having focused on many of the most high profile taxpayers, HMRC are turning their gaze on less obvious taxpayers. So even if the behavioural changes referred to in the statistics reduce the risk of transfer pricing adjustments and DPT charges for some taxpayers, we expect HMRC will continue to focus a significant proportion of its resources on cross-border transactions for the foreseeable future. Multinational taxpayers ignore this new reality at their peril.

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