# Keeping aware of red flags

Large Corporate OMB

16 January 2019

*Geoff Lloyd* provides an overview of HMRC's new Profit Diversion Compliance Facility

## Key Points

### What is the issue?

HMRC has announced a Profit Diversion Compliance Facility marking a further toughening of its approach to transfer pricing and diverted profits while enabling those who have tax to pay and wish to bring their affairs up to date to settle through a streamlined process which potentially involves no HMRC investigation.

## What does it mean to me?

Multinationals not already under HMRC investigation and whose transfer pricing arrangements may be seen by HMRC as creating a high risk of profit diversion from the UK should consider registering for the Compliance Facility.

## What can I take away?

For all multinationals, the new Profit Diversion Compliance Facility guidance, together with recently updated DPT guidance, confirm HMRC's rigorous approach to DPT and TP compliance, what HMRC sees as the 'red flag' indicators of profit diversion, and what HMRC expects by way of analysis and supporting documentation to substantiate transfer pricing arrangements.

## Overview of the disclosure facility

On 10 January 2019 HMRC launched a new disclosure facility called the Profit Diversion Compliance Facility (PDCF). This is aimed at multinationals which have used cross-border arrangements that HMRC considers result in an artificial reduction in UK profits, including arrangements targeted by the diverted profits tax (DPT) legislation. The PDCF is intended for use only where those arrangements are not already under investigation by HMRC. However, the PDCF guidance published alongside the announcement, and an update to HMRC's DPT guidance published in December 2018, have broader relevance because they confirm and make public developments in HMRC's approach DPT or related Transfer Pricing (TP) enquiries more generally. The launch of the PDCF comes along with a series of assertions as to tax at risk from alleged profit diversion and marks a new escalation in HMRC's approach to tackling perceived tax avoidance.

The launch of the PDCF follows HMRC's internal review of its DPT investigations to date and its risk review process of businesses not already under investigation. MNEs with undisclosed DPT or transfer pricing liabilities are invited to register for the PDCF and, within an agreed period (normally 6 months from registration), make a Report and Proposal containing a full and accurate disclosure of corporation tax (CT) or DPT liabilities for all in-date years, along with payment of the amounts disclosed. HMRC has stated that Proposals and payment of tax can be made on a ‘without prejudice’ basis. From January 2019 HMRC will be issuing warning letters to certain businesses assessed as high risk, drawing attention to the PDCF, and inviting the business concerned to consider registering. However, HMRC is making no commitments that it will send letters to all of the businesses identified as high risk in respect of profit diversion, and businesses at risk of HMRC investigation are warned that they should not wait for a warning letter.

Once a multinational has registered, HMRC will not investigate potential DPT or related (CT/ Withholding Tax/ VAT) liabilities during the agreed period, and provided HMRC is satisfied that the Report is appropriately evidenced and that the Proposal is reasonable and consistent with the arm’s length principle it will be accepted via a PDCF-specific governance mechanism, with no further enquiry or HMRC review of the underlying evidence on which the Report is based, and confirmation of a low risk outcome for profit diversion in the future.

HMRC will treat a disclosure made in response to a warning letter as unprompted, mitigating any penalty associated with that disclosure.

## Who might want to register for the PDCF?

For businesses at high risk of additional tax liability resulting from an HMRC diverted profits investigation, including those in receipt of a warning letter from HMRC, the PDCF appears to offer several advantages over a ‘wait and see’ approach, as outlined below.

Many businesses will have already thoroughly assessed their DPT risk, and where appropriate notified HMRC that they were potentially within the scope of DPT. While these businesses may want to revisit their DPT analysis in the light of the ‘red flags’ set out by HMRC in the PDCF guidance, unless this review changes their own risk assessment it seems unlikely that the PDCF will be of interest.

Businesses which are within the scope of DPT or are uncertain if they are within the scope of DPT and which have not already conducted a detailed review in respect of their compliance position may wish to seek professional advice.

Businesses already under audit from HMRC in respect of profit diversion are not eligible for the PDCF.

## What does HMRC consider the profit diversion risk indicators (‘red flags’) to be?

The PDCF guidance sets out a number of DPT/transfer pricing ‘red flags’ of a risk of profit diversion. These include situations where legal contracts allocate key risks to overseas entities but where the control of those risks is undertaken from the UK and the UK is given limited reward. Examples include commissionaire structures, limited risk distributors, toll or contract manufacturing arrangements, captive insurance, and contract research and development (R&D).

In respect of sales, marketing and distribution, HMRC’s ‘red flags’ include key regional leadership functions in the UK despite the transfer pricing structure giving the UK a low reward, and valuable UK account management roles, such as negotiating key commercial terms and performing pre- and post-sales support, despite the UK receiving a low reward.

HMRC also highlights concerns procurement hubs in low tax countries and the movement of supply chain functions from the UK to such countries, where this reduces the UK’s reward.

Finally, several risks are noted in respect of intangible assets, notably where an overseas entity in a low tax territory holds the legal title to valuable intangibles and receives the residual profit but the UK performs key functions in relation to the intangibles, or where the overseas entity has a modest headcount in relation to the UK in respect of the functions driving value.

## Detail of how the PDCF will work

The PDCF guidance sets out what HMRC will expect to be included in a Report and Proposal. In short, HMRC envisages that businesses registering will, either themselves or via engagement of an adviser, stand in the shoes of HMRC as investigator, establishing and documenting the relevant facts via a full review of the relevant evidence, including interviews with relevant personnel and examination of contemporaneous evidence including emails, setting out a detailed analysis of the application of all relevant tax law to the established facts, assessing behaviours in connection with any penalty exposure, and ensuring that the Proposal put forward is reasonable and in line with the arm’s length standard.

It is understood that HMRC believes that there are ‘hundreds’ of high risk cases and it has increased dedicated DPT resource to handle this work, whether through processing of Reports/ Proposals or investigating those who do not respond or whose Report/ Proposal is rejected. HMRC notes that, in a number of cases it has investigated, diverted profits have arisen from what it considers to be ‘deliberate’ inaccuracies in the transfer pricing policy, where the business has knowingly understated the importance and value of UK activity. In these cases, HMRC has started involving its Fraud Investigation Service which will potentially use the Publishing Details of Deliberate Defaulters legislation to ‘name and shame’ businesses found to have deliberately diverted profits out of the UK. We understand that the default HMRC response to businesses who do not register for the PDCF following a warning letter will be a Fraud-led investigation.

HMRC’s recently-updated DPT guidance describes what has become a highly intensive approach to its investigations, featuring detailed information requests (with formal notices where necessary) and an increasingly tough approach to the consideration of potential ‘careless’ or even ‘deliberate’ penalties and extended time limits for TP adjustments. This is mirrored by HMRC’s expectation that any PDCF disclosure will address the behaviours that led to any underpayment of tax and what penalties arise as a result.

The PDCF is expected to be run on a trial basis and developed over the course of 2019 depending on the response to the initial wave of warning letters and nature of the Reports/ Proposals submitted.

## How should businesses respond?

It is possible that, in some cases, a warning letter may be issued based on a misunderstanding of key facts, and there will be an opportunity for the business receiving the warning letter to engage with HMRC to explore that. For most cases where a warning letter is received, there must be a presumption that failure to register will (whether justified or not) lead to an in-depth and intrusive HMRC enquiry, and this could also apply to other cases that meet HMRC’s ‘red flag’ risk indicators. Registering for the PDCF will instead offer businesses the following potential benefits:

- *Control over the fact finding and enquiry process*. HMRC DPT investigations tend to be exceptionally resource intensive, with wide-ranging requests for information, documents and interviews with key individuals, and only limited levers available to the business in a DPT context to resist these. HMRC’s threat of Fraud-led investigations may also be relevant in some cases in future. So control over the process is of considerable value.

- *Lighter touch and accelerated approach to settlement.* While it remains to be seen how things will work in practice, the roposal is for a streamlined approach where HMRC accepts any reasonable and well-evidenced proposal, even though it might in its own enquiries have pressed for more information/documentation or for a higher settlement amount within the arm’s length range. HMRC aims to respond to Proposals within three months of submission and even in cases where the Report/Proposal is rejected, HMRC will take up from where the business’s position leaves off, rather than starting an investigation from scratch.
- *Potential reduction in penalties.* While in cases where the filed position is based on robust advice we would not expect HMRC to be able to sustain a ‘careless’ penalty at all, HMRC’s treatment of a response to a warning letter as ‘unprompted’ should in most cases enable the question of penalties to be taken off the table altogether. This will not be the case where HMRC investigates without the business first registering for the PDCF.
- *Reduced tax risk and potentially greater certainty for the future.* The PDCF guidance suggests that where the proposal is accepted by HMRC, this will give MNEs certainty for the past and a low risk outcome for profit diversion in the future.

## Conclusion

The launch of the PDCF and the publication of the associated guidance marks a further toughening of HMRC’s approach to transfer pricing and diverted profits. Whether or not HMRC’s perception of the tax at risk is justified in any particular case, multinationals targeted by HMRC for the issue of a warning letter, or where HMRC’s ‘red flag’ risks may apply, should consider registering for the PDCF with a view to securing its potential advantages.