Last chance to register

Large Corporate | Management of taxes

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Philippe Freund considers the reasons for making a disclosure under the Profit Diversion Compliance Facility

Key Points

What is the issue?

Businesses registering for the Profit Diversion Compliance Facility after 31 December 2019 will potentially be subject to higher penalties. Companies are therefore now running out of time to review their policies and contractual arrangements and to determine whether or not they ought to register under the PDCF in order potentially to eliminate or reduce penalties.

What can I take away?

Making a disclosure under the PDCF does not guarantee immunity from prosecution. Despite this there are a number of advantages in making a disclosure under the PDCF.

What does it mean to me?

By registering for the PDCF, a company has the opportunity to conduct the review of its existing transfer pricing arrangements, to identify potential issues and to make a focused disclosure to HMRC, thereby limiting the scope of HMRC’s scrutiny and the impact on day to day business. Any multinational engaging in this process must invest sufficient time and resources to make the report as compelling and resistant to challenge as possible.

On 10 January 2019, HMRC launched its Profit Diversion Compliance Facility (PDCF). This facility forms part of HMRC’s intensifying efforts to tackle perceived non-compliance by multinationals with legislation aimed to prevent them from shifting UK profits to low-tax jurisdictions. Businesses registering after 31 December 2019 will potentially be subject to higher penalties. Companies are therefore now running out of time to review their policies and contractual arrangements and to determine whether or not they ought to register under the PDCF in order potentially to eliminate or reduce penalties. The aim of this article is to provide an overview of the way in which the PDCF operates, as well as alternative ways of dealing with inconsistent practices and arrangements.

Background

The reason for the introduction of the PDCF is that HMRC, perhaps not unreasonably, suspect that, despite the introduction of the diverted profit tax (DPT) legislation in 2015, a large number of multinationals still operate transfer pricing arrangements which are based on a wrong fact pattern. Additionally, many do not comply with the OECD Transfer Pricing Guidelines, as clarified by Action Points 8 to 10 of the OECD’s

Base Erosion and Profit Shifting (BEPS) project. Some multinationals fall into both categories.

HMRC have declared tackling profit diversion as one of their priorities. As a result, they have created new investigation teams which aim and are trained to identify multinationals which might be diverting profits. HMRC have already identified a number of multinationals which they suspect might be diverting profits and have stated that they will write to them to invite them to review their transfer pricing policies. However, there cannot be any guarantee that HMRC will send such letters to every company at risk before opening a formal inquiry.

The aim of the PDCF is to encourage multinationals to review their transfer pricing approach and, if necessary, to bring it up to date and to inform HMRC of any additional tax that has been identified as being due.

Who should consider making a disclosure?

The PDCF is aimed at groups with operations in low tax jurisdictions. To date, HMRC's focus seems to have been on technology or e-commerce companies which have intellectual property assets located overseas that generate substantial profit. It is likely that once HMRC have dealt with this 'low hanging fruit', the focus will shift into other fields in the not too distant future. Any multinational which has not reviewed their transfer pricing policies in the light of the DPT and the changes to transfer pricing guidelines from the BEPS project should now re-examine these policies as a matter of urgency to determine whether it would be beneficial to register for the PDCF before 31 December 2019.

HMRC identifies five types of profit diversion risk indicators. If any of these indicators are identified during the examination of a multinational's arrangements, that company should, at the very least, consider registering for the PDCF.

1. Contractual arrangements with overseas companies

The first risk indicator includes contractual arrangements between companies within a multinational group which allocate risks to overseas companies, even though the control functions in relation to those risks are carried out in the UK (including, but not limited to, commissionaire structures, limited risk distributors, toll or manufacturing arrangements and contract R&D arrangements). It also includes contractual arrangements whereby valuable functions are fragmented into individual functions, either within the same or different UK entities of the same international group, which are then provided to overseas entities as individual functions at low cost.

2. Sales, marketing and distribution

The second indicator relates to sales, marketing and distribution activities and includes arrangements where functions such as determining commercial or pricing strategies, regional headquarter activities or important account management functions are carried out in the UK entities; but profits are attributed to entities situated in low tax jurisdictions which do not contribute to those functions in any significant way.

3. Supply chains

The third risk factor concerns supply chains, where the UK’s reward is diminished by moving supply chain activities to low tax jurisdictions or by carrying out procurement roles in those jurisdictions.

4. Presentation mismatches

The fourth risk indicator is where there is a mismatch between the presentation of R&D activities for patent box or R&D expenditure credits and the presentation made for transfer pricing purposes. It is clear that HMRC are comparing information gathered for one purpose against information proffered for another to examine compliance.

5. Intangible assets

The final risk indicator identified by HMRC relates to intangible assets. HMRC consider that there is a risk where intangible assets, such as intellectual property, are held by group entities in low tax jurisdictions which are paid the residual profits in circumstances where those entities either do not carry out any related functions or these functions are low value, where key functions are carried out by UK entities, where the related activities are contracted out to UK entities or where the headcount in relation to functions which drive value of the overseas entity is low compared to that of UK entities.

Why make a disclosure?

Making a disclosure under the PDCF does not guarantee immunity from prosecution (even though HMRC's criminal investigations policy makes it clear that HMRC are unlikely to prosecute matters which have been the subject of a full, accurate and voluntary disclosure). Despite this there are a number of advantages in making a disclosure under the PDCF.

Perhaps the most obvious and tangible advantage is the fact that making a disclosure will give rise to reduced (or, in certain cases, no) penalties. In addition, where a settlement proposal is accepted by HMRC, this gives absolute certainty for the past. From HMRC's perspective, they also see this as reducing the risk of profit diversion in the future.

Making a disclosure (as opposed to being caught up in an investigation) may also reduce disruption to the business, as it allows groups to exercise more control over the review process. A full-scale investigation by HMRC will usually examine all the arrangements an international group has put in place, even in situations where a large part of these arrangements are unlikely to breach existing profit diversion rules. By registering for the PDCF, a company has the opportunity to conduct the review of its existing transfer pricing, to identify potential issues and to make a focused disclosure to HMRC, thereby limiting the scope of HMRC's scrutiny and the impact on day to day business.

It should of course be borne in mind that in order to offer effective protection, the disclosure needs to be complete; i.e. it needs to identify and disclose all arrangements which could potentially fall foul of anti-profit diversion legislation. Whilst HMRC will not take further actions in relation to arrangements which were disclosed to it and which have been the subject of an agreed settlement, any non-compliant arrangements which failed to be disclosed to HMRC will remain open to HMRC investigations. If HMRC identify arrangements which ought to have been disclosed as part of the initial PDCF disclosure but were not, this will, in all but the most exceptional cases, lead to a more robust approach being taken in the subsequent investigation, both as to the scope of the investigation and as to the severity of the consequences, thereby negating all the benefits of the initial disclosure.

Finally, HMRC have made it clear that they do not intend to apply the Publishing the Details of Deliberate Defaulters legislation to any multinational which makes a full disclosure under the PDCF. Making a disclosure therefore reduces the risk of reputational damage to the company.

Mechanics of the PDCF

In its PDCF guidance, HMRC sets out what steps it expects companies to carry out in preparing the report and proposals. The guidance is fairly detailed and identifies the relevant facts and evidence which HMRC expect to be covered in the disclosure report, together with the requirement for the underlying legal and economic analysis and the taxpayer’s submissions as to conduct and applicable penalties. The guidance suggests that HMRC expect businesses making a disclosure to conduct a full and in-depth analysis, in effect taking over the role an HMRC investigator would otherwise perform.

HMRC expect full technical analyses to be carried out with regard to any of the following areas which have been identified as risk areas by the company: transfer pricing, diverted profits tax, permanent establishments, corporate residence, withholding tax, controlled foreign companies, and hybrid and other mismatch rules. Where it is clear that there is no significant risk in any particular area, then a brief comment explaining why this is the case will suffice.

As will be apparent from this list, making a disclosure can lead to additional questions being raised by HMRC. It should also be borne in mind that there is no guarantee that HMRC will accept the disclosure report and the conclusions it reaches as to tax due and penalties. It is therefore important that any group engaging in this process invests sufficient time and resources to make the report as compelling and resistant to challenge as possible. Given the level of technical analysis required, this will in most cases mean seeking specialist professional advice in the preparation of the disclosure report.

Alternatives to the PDCF

In circumstances where minor and self-contained shortcomings or factual inaccuracies have been identified, this may not warrant incurring the significant time and financial expenditure required to establish a formal report under the PDCF. In those circumstances, companies should consider making a simple voluntary disclosure as an alternative.