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HMRC profit diversion compliance facility: are you really BEPS-compliant?

HM Revenue & Customs' (HMRC) recent introduction of a new Profit Diversion Compliance Facility (the facility) is a clear signal of its commitment to implementing the Base Erosion and Profits Shifting (BEPS) agenda. Although diverted profits tax (DPT) compliance and review of transfer pricing policies will be a large part of any multinational's decision on how to respond to the facility, the question for a company is not just whether its transfer pricing policies are up-to-date but, more widely, whether its structure is demonstrably BEPS-compliant (*see box "BEPS and profit diversion"*).

After recent enquiries into profit diversions found businesses with serious deficiencies, HMRC has warned that there will be further investigations in this area and, by launching the facility, has opened an opportunity for taxpayers to self-report. HMRC has also warned that its Fraud Investigation Services could be involved in these further investigations, which indicates the seriousness with which HMRC is treating this issue.

The facility offers some limited protection on penalties to businesses using it, but these protections are all within current HMRC penalty legislation and guidance. Unlike other HMRC disclosure facilities, there is no real element of amnesty and no immunity from further civil or criminal investigation.

BEPS and profit diversion

Base Erosion and Profit Shifting (BEPS) was a project undertaken by the Organisation for Economic Co-operation and Development and G20 to address perceived weaknesses in international tax rules that, in particular, allowed multinational enterprises to avoid or minimise taxation. The BEPS project aimed to ensure that profits were taxed where economic activities took place and where value was created to restore confidence in the international tax framework.

With effect from 1 April 2015, the diverted profits tax (DPT) was introduced in the UK with the aim of targeting large corporate groups that had supposedly used their global reach to divert taxable profits away from the UK to low tax territories (*see News briefs "Diverted profits tax: the next step down the road", www.practicallaw.com/8-610-3069 and "Diverted profits tax: reports of its death are greatly exaggerated", www.practicallaw.com/w-008-3373*). By implementing the DPT, the UK was keen to get a headstart on implementing the BEPS project outcomes, and further steps, such as the UK's announcement of a digital services tax have suggested that the UK will continue to take a lead in countering perceived abusive arrangements and out-of-date rules. In countering diverted profits, HM Revenue & Customs uses a range of legislation of which the DPT is just one part.

Risk-based review

HMRC has issued guidance to accompany the launch of the facility (*www.gov.uk/government/publications/hmrc-profit-diversion-compliance-facility*). Anyone who has followed the Organisation for Economic Co-operation and Development and G20 BEPS project will be familiar with the risk indicators discussed in the guidance, yet HMRC is of the view that many businesses are still not complying and that action is needed (*see News brief "The OECD's action plan on BEPS: a taxing problem", www.practicallaw.com/0-538-9745*). Factors such as the following are singled out as hallmarks that a multinational's structure may be viewed as high risk by HMRC:

- Whether the contractual allocation of risk differs to the control over that risk.
- UK entities performing key strategic roles, or valuable research and development, but with modest compensation.
- Residual profits arising to the holder of bare legal title to assets.

HMRC is concerned about more than just transfer pricing. In the guidance, HMRC states that it has seen discrepancies between documents and the reality of implementation. A disconnect, perhaps, between how the business operates and how the tax function sees the business as operating.

This gives rise to wider concerns. For example, if the contractual allocation of risk is inconsistent with how that risk is controlled in reality, putting aside the sensitive question of whether the UK company's tax returns are careless, this might have an impact on whether the non-UK company is really non-UK tax resident. Or, if a shareholders' agreement is operating in practice in a different manner to what is written on the page, this could mean that the company is a controlled foreign company. The answers to these questions could have wider implications than can be solved through transfer pricing adjustments, and could also have ramifications for the business's tax position spanning back to before the introduction of DPT in 2015.

"Misconceptions" about DPT

HMRC's facility guidance also contains examples of what it considers to be misconceptions about the operation of DPT. Some of these are to be expected where a new tax, with new concepts, beds down. One misconception cited is the "overvaluing" of the non-tax benefits of a transaction when a business applies one of the important DPT gateway tests: the insufficient economic substance condition. This may be understandable where companies are grappling with identifying and valuing benefits of a particular transaction against a long-established group structure.

Some of the misconceptions could give rise to wider implications. For example, the identification of the "material provision" for the insufficient economic substance provision requires a business to look at the overall arrangements, meaning that the parties to the "material provision" may not be the immediate parties to a transaction. The facility guidance says that other tax risks related to the arrangements also need to be investigated. This might include, for example, whether the identification of a "material provision" which is between related parties who are not the immediate parties to a transaction affects the VAT analysis. Other issues include whether the

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transaction is still properly categorised from a VAT perspective, and whether the place of supply has changed.

Timing is all

Against this landscape, the first step for multinationals is to ensure that the organisation's structure, contracts, working practices and transfer pricing policies are reviewed against HMRC's facility guidance. Following that review, if the business is confident that none of the risk indicators is present, the organisation can, for now, safely do nothing. However, if the review does bring concerns to light, the timing of next steps needs to be considered carefully.

Although there is no current end date for the facility, only those who register before 31 December 2019 will be potentially eligible to have a DPT penalty for failure to notify reduced to nil. The facility is not open to businesses that are already under a profit diversion investigation on that issue. HMRC will issue some "nudge" letters, in tranches, to encourage businesses that it considers may need to enter the facility but will also continue to open enquiries without issuing a letter first. An open investigation will prevent use of the facility. Therefore, if a business considers that it may want to use the facility, it should carefully consider the timing of registration.

Balanced against the benefit of registering early is the work involved in producing the report that is required under the facility. Following registration, taxpayers will generally have six months to complete and submit a detailed report (and make payment of any self-assessed tax, interest and penalties) on a without prejudice basis. HMRC is expecting a very detailed review to be undertaken to support the position taken in the report. This would include testing the facts on which transfer pricing documents is based, and testing whether the contractual allocation of risk is borne out by the reality of operations.

At a practical level, this means that managers and staff (UK and non-UK) need to be interviewed and contemporaneous communications should be reviewed and considered. The internal investigation necessary to support the report will be a time-consuming exercise and will require commitment from the business and, in terms of scope and level of detail, is unlikely to fall too far short of an HMRC investigation. The benefit, however, of the facility is control over that investigation.

Why use the facility?

Without an amnesty or reduced penalties, there are a number of reasons why a taxpayer would want to use the facility. The key benefits are:

- Speed of resolution.
- Control over the internal investigation.
- Certainty over the past and a low-risk position for the future.

A more nuanced benefit is that the report is provided to HMRC on a without prejudice basis, which limits the potential downside.

HMRC's handling of the use of the facility will also affect its take up. Of course, there is the implicit threat that if the facility is not used when HMRC considers that it should be, taxpayers will find themselves in hotter water in the long term: that is the stick. But HMRC should not miss the opportunity to offer a carrot; a collaborative experience for taxpayers that gains a reputation for delivering a successful outcome.

HMRC will want to underpin the take-up of the facility by accepting as many reports as it reasonably can without allowing poor quality reports to go unchallenged. HMRC knows that the prospects of the facility achieving its objectives will be damaged if it is perceived to be unwilling, in the first few months, to accept well-constructed reports.

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