Transfer pricing: The rising risks and costs of non-compliance

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Transfer pricing is high on groups’ lists of major tax risks. Buoyed by its recent success in more than doubling its take from transfer pricing and diverted profits tax investigations, HMRC launched a Profit Diversion Compliance Facility (PDCF) in January 2019. In doing so they have put Multi-National Enterprises (MNEs) on notice that they see widespread non-compliance with BEPS in their cross-border arrangements.

HMRC nudged a small group of taxpayers to register for the PDCF in January and has recently started investigating those that did not. A second batch of nudge letters was issued in early June and a third batch is expected in the Autumn as HMRC gear up to challenge more transactions and structures of groups with a UK presence.

The cost to taxpayers of getting their transfer pricing wrong is rising with HMRC now adopting a more rigorous and aggressive approach to levying penalties when transfer pricing enquiries result in an adjustment to the filed tax return. Taxpayers should be aware that these penalties can be substantial, with HMRC increasingly seeking to interpret inaccurate statements presented in transfer pricing documentation as deliberate inaccuracies subject to a potential 70% penalty.

Any MNEs who have not performed a BEPS compliance review covering their transfer pricing arrangements should undertake one, and where risks are identified, consider registering for the PDCF or other approaches to bring matters up-to-date such as Advance Pricing Agreements (with roll-back).
The changing tax environment

Tax authorities across the globe are increasing scrutiny on the pricing of transactions between group companies. In the UK, we see HMRC prioritising transfer pricing and profit diversion compliance reviews. It is adopting an evidence-based forensic approach to its enquiries, using extensive data profiling and research to inform its selection of taxpayers for investigation. This now includes reviewing businesses which HMRC may previously have seen as lower risk, including medium-sized businesses. Significantly, HMRC launched the PDCF in January 2019 and has issued targeted ‘nudge’ letters to certain MNEs who may have felt they were ‘under the radar’. In June HMRC issued a second small targeted batch of nudge letters. Given the initial success of the PDCF we expect HMRC will issue a further batch later in the year.

| Risk alert #1 |
| Is your company at risk of a transfer pricing enquiry? Specific risk factors highlighted by HMRC include: |
| — Control functions in the UK where risk has been allocated away from the UK to overseas affiliates in intra-group agreements underpinning low risk characterisation for UK entities (e.g. commissionaires, limited risk distributors, toll/contract manufacturing and contract R&D arrangements). |
| — Sales and marketing functions in the UK which add significant value where the majority of the profits are routed to overseas entities with lower functionality. |
| — Failure to adapt transfer pricing policies where UK entity’s role evolves from being a locally focused business to a regional headquarters or has significant people functions with global responsibility. |
| — Intangibles owned by an overseas affiliate with low functionality and functional analysis indicates UK entities are performing key risk control and other DEMPE functions related to the offshore intangibles. |

HMRC expects certain evidence to support the transfer pricing approach adopted to be created before a tax return is submitted for the period in question.

Evidence to support the transfer pricing methodology

HMRC views a taxpayer’s primary transfer pricing documentation as advocacy rather than fact, containing a carefully selected set of facts and evidence used to build a narrative supporting the taxpayer’s transfer pricing arrangements. Accordingly, when HMRC opens enquiries into transfer pricing it will generally want to test the extent to which the conclusions in the report are evidence-based and reflect how the business operates in reality. Formal transfer pricing documentation will rarely be sufficient to resolve a transfer pricing enquiry by itself but the quality of the documentation is important in mitigating the risk of penalties.

| HMRC expects certain evidence to support the transfer pricing approach adopted to be created before a tax return is submitted for the period in question. This evidence includes: primary accounting records of individual transactions; identification of transactions to which the transfer pricing rules apply, the terms of those transactions and their outcome; and records supporting any adjustments made between the transaction values shown in the accounts and those reflected in the tax return. |
When it comes to evidence on whether “in scope” transactions in the tax return are in keeping with the arm’s length principle, the onus is on the taxpayer to be able to explain the steps taken before filing the tax return to satisfy themselves that they were compliant with the transfer pricing rules.

| Risk alert #2 |
| Is your company able to produce evidence pre-dating the tax return’s approval to support adjustments between the accounts values and tax return values related to transfer pricing or that no adjustment is required (e.g. thin capitalisation)? |

| Risk alert #3 |
| Updated OECD Transfer Pricing Guidelines were released in July 2017 and HMRC have clearly set out in their PDCF guidance that there is an expectation that MNEs will have reviewed their transfer pricing arrangements to comply with the revised guidelines, in particular the parts which incorporate BEPS Actions 8 to 10. |
Increased rigour by HMRC in enforcing penalty regime

Until recently it was relatively rare to see HMRC impose penalties in relation to transfer pricing compliance due to the nuances involved in pricing intercompany transactions and tendency of taxpayers to take professional advice. However, there has been a marked shift in HMRC’s approach post-BEPS and they are taking an increasingly rigorous and aggressive approach to levying penalties.

HMRC case teams who have made a transfer pricing adjustment are required to consider whether penalties should apply. HMRC typically asks the taxpayer to provide evidence to enable HMRC to consider whether reasonable care has been taken and what level of penalty (if any) would be appropriate. In practice it is difficult for taxpayers to explain the details of events leading up to a tax return being submitted, as this was often several years ago.

Significant penalty decisions are reviewed by a Penalty Consistency Panel so individual Customer Compliance Managers and caseworkers have less discretion on penalties than they had in the past.

HMRC can charge penalties where there is an inaccuracy in a tax return which results in an understatement of tax (or overstatement of losses) and the inaccuracy was as a result of careless or deliberate behaviours.

How would you answer this question?

“When the tax return for the year ended 31 December 2017 was signed by the responsible person, what measures were undertaken to ensure the related party transactions for the UK company were in line with the arm’s length principle?”

HMRC penalty ranges

<table>
<thead>
<tr>
<th>Reason for inaccuracy</th>
<th>Unprompted disclosure</th>
<th>Prompted disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% of potential lost revenue</td>
<td>% of potential lost revenue *</td>
</tr>
<tr>
<td>Lack of reasonable care</td>
<td>0% - 30%</td>
<td>15% - 30%</td>
</tr>
<tr>
<td>Deliberate error</td>
<td>20% - 70%</td>
<td>35% - 70%</td>
</tr>
<tr>
<td>Deliberate and concealed</td>
<td>30% - 100%</td>
<td>50% - 100%</td>
</tr>
</tbody>
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*Potential lost revenue is broadly equivalent to the additional tax arising from the adjustment.

There is an increasingly fine line between what constitutes careless behaviour and deliberate behaviour, but the distinction can have significant consequences for the level of the penalty and the possibility to suspend the penalty.
HMRC is increasingly reviewing the boundary as to what is reasonable care and what constitutes a deliberate error. This is a finer line than many will realise. In *Auxilium Project Management v HMRC (2016)*, the First-tier Tribunal (FTT) found that “a deliberate inaccuracy occurs when a taxpayer knowingly provides HMRC with a document that contains an error with the intention that HMRC should rely upon it as an accurate document.” In another 2016 case involving penalties for VAT errors the FTT took a broad view on what is deliberate:

Our view is that, depending on the precise circumstances, an inaccuracy may also be held to be deliberate where it is found that the person consciously or intentionally chose not to find out the correct position, in particular, where the circumstances are such that the person knew that he should do so. A person cannot simply escape liability by claiming complete ignorance where the person clearly knew that he should have taken steps to ascertain the position.

We view the case where a person makes such a conscious choice not to take such steps with the result that an inaccuracy occurs, as no less of a “deliberate inaccuracy” on that person’s part than making the inaccuracy with full knowledge of the inaccuracy.

*First-tier Tribunal decision in Clynes v HMRC [2016]*

A further consequence of a deliberate inaccuracy is that it could lead to inclusion on HMRC’s list of ‘deliberate defaulters’ – a list that HMRC publishes online of the names and details of taxpayers where an investigation has concluded there was a deliberate inaccuracy in a tax return. This could result in significant reputational damage for a business.

Bringing this back to transfer pricing, whilst the above cases are first tier tribunal judgements (and therefore not binding for other taxpayers), they are useful indicators as to the approach that we can expect HMRC to adopt.

Taxpayers should be aware that HMRC are increasingly contending that inaccurate statements presented in documentation are deliberate inaccuracies (attracting a potential 70% penalty) if the taxpayer has relied on outdated transfer pricing documentation which does not reflect the facts of evolved business operations accurately. It could be contended that deliberate behaviour includes situations where a taxpayer makes a conscious choice to submit their transfer pricing documentation to HMRC without checking its accuracy and knowing that there have been changes to business activities which may impact on the accuracy of the report and reliability of its findings. Accordingly, taxpayers should ensure that before they submit transfer pricing documentation to HMRC or any other tax authority they have adequately validated the functional analysis and other key facts underpinning the transfer pricing methodology to ensure their accuracy.

If you are doing a roll-forward exercise on your documentation you must check the facts haven’t changed. Few globalised businesses will remain static over a three year period so make sure you have understood what has changed and discuss the transfer pricing impact of these changes with your advisor.

The guidance recently issued by HMRC in relation to the Profit Diversion Compliance Facility reinforces these points:

Our investigations into Profit Diversion to date have established that in a large number of cases the factual pattern outlined to HMRC at the start of an enquiry does not stand up to scrutiny once tested. That may be a result of a careless error (for example individuals within a group being unaware of what the actual facts are) but it may also be a result of a deliberate behaviour, that is a group knowingly submitting a TP methodology in a Corporation Tax Return based on a false set of facts. A common issue is an overstatement of functions performed, assets used and risks assumed in entities taxed at lower rates, and an understatement of the functions performed, assets used and risks assumed in the UK.
HMRC expects businesses to have reviewed their transfer pricing policies in light of BEPS Actions 8 to 10. For corporation tax returns filed from 2018 onwards HMRC could argue there has been a failure to take reasonable care, or even deliberate behaviour, where an adjustment arises wholly from a failure by the taxpayer to consider the guidance and clarifications in the Report on BEPS Actions 8 to 10 (as adopted in the 2017 OECD Transfer Pricing Guidelines) before submitting their returns, where the impact of applying the new guidance makes the filing position taken no longer reasonably arguable.

Whether a disclosure is treated as prompted or unprompted depends on how HMRC became aware of it. If HMRC opened a transfer pricing enquiry into that area, the disclosure is classified as prompted. A voluntary disclosure made with no chance that HMRC would have otherwise been aware of the inaccuracy is unprompted. This is not a black-and-white matter and different potential scenarios exist between these two ends of the spectrum. Significantly, HMRC is willing to treat disclosures made through their PDCF as unprompted, including where a taxpayer registers following a nudge letter.

**Risk alert #4**

Does your company think transfer pricing and penalties do not apply to loss-making UK companies? Where a company has made a loss, the potential lost tax revenue for penalty purposes is calculated as 10% of the adjustment to the losses yet to be used. If the losses have been used then the calculation refers to the tax saved by using the overstated losses.

**Reduction of penalties for disclosure**

Penalties can be reduced to a certain extent depending on the quality of disclosure made to HMRC by the taxpayer. Mitigating factors can include the extent to which the taxpayer:

- Tells HMRC about the inaccuracy
- Gives HMRC reasonable help in quantifying the amount of the inaccuracy
- Allows HMRC access to records to ensure that the inaccuracy or under-assessment is fully corrected

Playing a waiting game could damage the opportunity for penalty mitigation: HMRC has indicated that it expects taxpayers to identify and disclose the inaccuracy within three years from the date the inaccuracy first occurred.

**Suspended penalties**

Where a careless error has occurred, HMRC may agree to suspend the penalty provided certain agreed conditions are met over a set time period.

The conditions will depend on the facts of each case but they should be specific, measurable, achievable, realistic and time-bound, and include a general condition that returns for all taxes must be filed on time during the suspension period.

Penalties cannot be suspended for deliberate inaccuracies or inaccuracies that arise from one-off transactions as the suspension is intended to be an incentive to promote compliant behaviour.
Professional advice

Many businesses engage professional advisors to help them articulate and benchmark their transfer pricing approach within a group. However, we are seeing an increasing number of cases where HMRC has concluded that a business has failed to take reasonable care, even though it had taken third-party advice from an appropriately qualified professional advisor.

Risk alert #5

Does your company believe there is no risk of penalties because they have taken advice from a professional advisor? The onus is on the company to make sure the advice is appropriate for the group’s operations in every return period.

Companies need to be aware that the reasonable care test is applied to the taxpayer, not their advisor/agent. It may be reasonable for a business to rely on external advice, but this depends on all relevant information being made available to the advisor at the time the advice was prepared, and that the application of this advice is reviewed for each period to ensure that facts and underlying assumptions are still accurate.

We have seen HMRC seek to charge penalties where:

- A company failed to provide relevant information on the company’s performance to an advisor.
- A company did not consider whether the transfer pricing advice it had specifically requested in respect of a narrow range of intra-group services was suitable in respect of a wider range of services.
- A business did not take adequate steps to ensure that the transfer pricing advice it had received was properly implemented in practice.

How can your company reduce the risk of incurring transfer pricing penalties?

- **Being up to speed**: Familiarise yourself with HMRC’s PDCF guidance.
- **Ensure you can evidence that you have reviewed your existing transfer pricing arrangements to comply with the revisions to the OECD transfer pricing guidelines introduced by BEPS Actions 8-10 and any recent changes to your business operations.**
- **Complete documentation**: Ensure you have a complete set of primary transfer pricing documentation that includes all the information listed in Chapter V (and its Annexes) of the latest OECD transfer pricing guidelines.
- **Align information**: If you are large enough to be making country-by-country reporting filings check the alignment between the Master File and the results shown in the country-by-country reporting.
- **Check supporting evidence**: Plan ahead by interrogating your own primary transfer pricing documentation and collecting detailed evidence that would support the accuracy of the key facts and statements contained in the primary documentation in the event of a tax authority audit.
- **Increase efficiency**: Consider using technology to support you in gathering evidence efficiently. KPMG’s digital communication analytics tool can add greater depth to transfer pricing documentation by evidencing decision making and control of risk and supporting the benefit test for intra-group service transactions.

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