

Profit Diversion Compliance Facility – HMRC letters to multinational enterprises

An update to CIOT members

This update provides some background to HMRC's Profit Diversion Compliance Facility (PDCF) and guidance to help members provide advice on the most appropriate way to respond if a client, or the business that they work for, receives a letter from HMRC suggesting that they review their cross border arrangements. We consulted HMRC to check that this update accurately reflects their position.

Background

Companies should recognise and pay tax on profits where the economic activities to generate those profits are carried out. The correct amount of profits which should be taxed in the UK is determined in accordance with the UK's tax legislation and international tax law principles, in particular the laws and principles relating to transfer pricing.

Most multinational enterprises (MNEs) work hard to ensure that their transfer pricing policies and business structures are such that they pay UK corporation tax in line with their economic activity. However, some MNEs have adopted cross border transfer pricing arrangements which do not entirely, or no longer, reflect the commercial reality or economic activity and which result in a reduction of UK profits. Such arrangements may involve the diversion of UK profits to an overseas entity where the profits are taxed at lower rates or not at all.

HMRC have said that tackling this profit diversion is a priority for them. Since the introduction of the diverted profits tax (DPT) in 2015 HMRC has invested significantly in research and data analytics tools to identify profit diversion amongst MNEs, and has been running an extensive programme of investigations. We understand that so far HMRC has completed over 80 diverted profits investigations, there are around 100 more underway and HMRC's programme of research and investigation continues.

HMRC report that in a high proportion of their investigations the cross border arrangements do not stand up to scrutiny and significant additional tax is due. HMRC consider this is the case for two main reasons. First, there is a divergence between the fact pattern on which the transfer pricing analysis is based and what is actually happening on the ground. Second the transfer pricing policies are not in accordance with the OECD Transfer Pricing Guidelines, for example because of:

- over reliance on transfer pricing policies predicated on contractual assumption of risk and legal ownership of assets, giving insufficient weight to the location of the control functions and/or the contributions to those control functions in relation to the risk and/or the important functions in relation to the assets; and
- too heavy a reliance on inappropriate comparables.

Profit Diversion Compliance Facility (PDCF)

In January 2019 HMRC launched a new compliance facility – the PDCF. HMRC's guidance on the PDCF can be found at: [HMRC Profit Diversion Compliance Facility Guidance](#).

The PDCF remains open and available to all MNEs.

HMRC are calling for MNEs to read its guidance, review their tax affairs and, where applicable, use the facility to disclose any additional UK tax liabilities from past accounting periods, taking into account statutory assessment time limits. HMRC are encouraging them to make proposals to pay any additional tax due on the diverted profits and, if applicable, any interest or penalties owed. A key benefit of registering to use the facility to put forward a report with proposals to pay any additional tax, interest and, where applicable, penalties due is that this will be deemed an 'unprompted' disclosure for tax-gated penalty calculation purposes if HMRC have not already started an investigation into profit diversion.

HMRC are also identifying and writing to specific MNEs they believe could be diverting profits away from the UK.

We understand that HMRC are encouraged by progress and have said that:

- around two thirds of the MNEs receiving letters have registered to use the facility;
- some businesses that have not received a letter have taken the opportunity put their tax affairs on a better footing and have registered to use the facility;
- they have received some excellent feedback on the process, with businesses completing it generally finding it an efficient, transparent and cooperative way to bring their tax up to date; and
- HMRC are following-up with businesses which decided not to register, including starting investigations.

In light of the COVID-19 pandemic, HMRC paused their programme of issuing letters but in September 2020 sent out another batch.

What's in the letters?

HMRC's letters use standard wording and start by recommending that the letter be shared with the group's UK Senior Accounting Officer, if there is one, and/or Chief Financial Officer and those people responsible for the group's international accounting and tax compliance.

The letter then goes on to ask - How confident are you that your transfer pricing is appropriate and the DPT legislation does not apply to you?

The letter states that the corporate group of which you (being the company the letter is addressed to) are a member has been identified as being potentially liable to DPT and goes on to say this is because your group has features commonly associated with arrangements targeted by the DPT legislation. HMRC have confirmed to us that the intention of the wording is for the MNE to view the letter as aimed at their UK operations as a whole rather than being restricted to the UK company that the letter has been addressed to.

The letter cites a number of recent developments in international taxation, including the G20/OECD Base Erosion and Profit Shifting project, and references that many businesses have changed their transfer pricing and/or business structure leading to the right amount of UK corporation tax being paid, eliminating any potential liability to DPT.

The letter then refers to the PDCF guidance and details the benefits of registering and using it.

The letter gives the MNE 90 days to decide whether to register for the PDCF. It says that if the business does not register for the PDCF in this timeframe HMRC may follow up with an investigation. HMRC have confirmed that they are following up immediately with investigations with the majority of businesses that do not register.

The letter suggests discussing its contents with a tax adviser to decide whether to register for the PDCF. A copy of the letter is sent to the company's registered tax agent on HMRC's systems (if there is one). For MNEs that have an assigned Customer Compliance Manager (CCM) from HMRC, the CCM is copied into the letter and in practice the CCM also typically sends an electronic copy of the letter to their main tax contact at the MNE.

What should you do if a client, or the business that you work for, receives one of these letters from HMRC

1. Work with the business to ascertain and risk assess its position.

HMRC only sends a letter if their risk assessment and triaging identifies features commonly associated with profit diversion. Therefore, if you receive a copy of a letter from HMRC regarding the PDCF, or are otherwise aware that a UK business that you are engaged by or work for has received such a letter, you should encourage the business to engage with and respond to the letter. This is the case even if the business initially indicates that it is up to date with its tax affairs or, for example, previously had an advance pricing agreement, been subject to an audit but no adjustment was made, or had adopted a new model after reaching a settlement agreement, and, consequently, considers that its transfer pricing policies are acceptable to HMRC. It should also be noted that profit diversion is wider than DPT, so even if a business says that it has considered its affairs and concluded that it is not liable to DPT, there may still be aspects of its business to consider in relation to the PDCF.

You should seek to ensure that the letter is considered at the appropriate level within the business. If you are aware that the UK operations are a relatively small part of the broader multinational business, or you are engaged on 'compliance only' basis, it is important to ensure the letter is passed onto the relevant team within the MNE which does have responsibility for the overall transfer pricing policies of the business.

If you are not the registered tax agent for the MNE that you are engaged by (and, therefore, would not expect to receive a copy of a letter from HMRC if one was sent to your client), you may consider inquiring whether or not the UK company that you are engaged by (or another UK company in the same group) has received a letter from HMRC about the PDCF and, if it has, provide the advice as above: that the UK business should engage with the letter and seek to deal with it in an appropriate manner.

It should be recognised that the receipt of a letter from HMRC about the PDCF is the start of a process. Undertaking a review to reach a decision about how to respond to HMRC, whether or not to register with the PDCF and, if appropriate, utilising the facility will involve a considerable amount of work on the part of the MNE and its advisers. Part of this review process should involve a consideration with the business about the financial costs and disruption to the business that will be involved as a result of either registering to use the PDCF or from an HMRC investigation that is very likely to follow if a letter is received and the business decides not to register with the PDCF or otherwise respond to HMRC before the 90 day deadline.

A CIOT member must comply with the Professional Conduct in Relation to Taxation (PCRT). A fundamental principle of PCRT is that of professional competence and due care. This means that members should not undertake professional work which they are not competent to perform unless they obtain appropriate assistance from a suitably qualified specialist. Advice from another adviser

specialising in structuring cross border businesses, transfer pricing and/or tax dispute resolution may therefore be needed if the agent does not have the necessary expertise to:

- carry out the review;
- advise the MNE whether to register to make a disclosure via the PDCF or how best to respond if the PDCF is not appropriate; and
- if appropriate, prepare the disclosure (including the proposal of the tax, late payment interest and tax-geared penalties due) for the MNE's approval and submission as well as advising the MNE throughout the PDCF process..

If you are engaged to do so you should work with the business to ascertain and risk assess their position, and then reach a decision about how to respond to the letter. [HMRC's Profit Diversion Compliance Facility Guidance](#) will be a useful tool when performing this exercise. HMRC have indicated that the guidance is to be reviewed and updated, including to reflect what has been learnt since the PDCF was introduced.

2. Respond to HMRC's letter, whether or not it is considered there is anything to disclose.

Tax risks identified

If on review of the MNEs business and transfer pricing policies, and HMRC's PDCF guidance, it is recognised there are tax areas where HMRC may take a different view than that adopted by the MNE, then registering for the PDCF should be considered bearing in mind that HMRC are very likely to follow up with non-registrants. Registration with the PDCF recognises that there is a risk that additional tax may be due, but it is possible for the result of the process to be an agreement that there are no diverted profits.

If the MNE decides to register for the PDCF then the letter explains how to do this.

In places the draft guidance sets out an HMRC view of certain technical points and of the risk associated with certain fact patterns. It is helpful to be aware of HMRC's position and the view that HMRC would take in an investigation. However, some of the material in the guidance may be considered arguable and the correct position will depend on specific facts in each case; the position being taken in the guidance is no more than HMRC's view.

In appropriate circumstances, therefore, to the extent an MNE disagrees with HMRC's views as set out in the guidance, it may decide not to make any disclosure under the facility. In this situation, the MNE is effectively put on notice that there is a high risk that HMRC will challenge the MNE's transfer pricing policies and/or DPT analysis in a subsequent enquiry or investigation. The MNE may decide to disclose under the PDCF, set out their factual position, present their own technical view of the relevant tax rules and explain why they consider that they are paying the right amount of tax. MNEs should recognise the potential penalty position if they do not utilise the PDCF particularly if they receive a nudge letter, as discussed above. Alternatively, the MNE may send HMRC an explanation by letter (see "*No tax risks identified*" below) in order to avoid the situation of not responding at all.

If tax risks are identified following a review of HMRC's PDCF guidance but the MNE would prefer not to register because it considers no additional tax is due then agents should ensure they advise the MNE of the likely implications including what a follow up HMRC investigation is likely to entail, the likely costs and the tax-geared penalty implications (including inaccuracy penalties and failure to notify DPT penalties). If additional tax is considered to be due and the MNE decides not to disclose it

to HMRC then members must follow the PCRT guidance on errors (See [PCRT help sheet C: Dealing with errors](#) and [PCRT helpsheet C2 Dealing with errors – Members in business](#)).

It is important to note that there is no de minimis level for disclosure of mistakes.

No tax risks identified

If on review of the MNEs business and transfer pricing policies, and HMRC's PDCF guidance, it is decided there are clearly no tax risks where HMRC are likely to take a different view of the analysis to that adopted by the MNE, then the MNE should consider sending HMRC an explanation by letter.

HMRC will take account of responses when deciding whether and when to follow up with an investigation. HMRC have said that any such letter should explain in detail why it is clear that there is no profit diversion or transfer pricing risks and provide evidence to support this. If it is not clear whether HMRC would take a different view of the analysis adopted by the MNE then HMRC's position is that they would prefer for the MNE to register for the PDCF.

Where no response to their letter is received, HMRC are very likely to follow up with an investigation.

Time period

It is recommended that MNEs should respond within the 90 days provided by HMRC. However, if it is not possible or practical to respond fully to the letter within this timescale, MNEs should consider contacting HMRC through its dedicated [PDCF registration mailbox](#). Reasons for not being able to comply with the 90 days provided (that have been discussed constructively with HMRC to reach a practical outcome) have included a recent or pending sale of part or all of the relevant UK business or, in recent months, a lack of relevant staff available with the necessary information due to the staff being on furlough. If an MNE has these sort of issues, we suggest that it contacts HMRC at the earliest opportunity and does not wait for the 90 days to elapse.

HMRC have stated that once the 90 days are up then the MNE is at risk of an investigation and no guarantees can be made that an investigation will not be started after the 90 day time limit if a registration for the PDCF has not been made. However, they have also confirmed that if the customer contacts this mailbox and sets out plans to register or reply shortly after the 90 day time limit then HMRC would factor that into their decision on whether and when to follow up.

With increasing data sources now available to HMRC and HMRC's recent experiences in concluding significant numbers of profit diversion investigations for substantial transfer pricing adjustments, it is expected that HMRC will continue to focus on international tax compliance of MNEs in the coming years. HMRC are adopting an approach of sending out batches of letters at regular intervals with respect to the PDCF. Members should be aware that this approach will continue for the foreseeable future.

Chartered Institute of Taxation

September 2020