

IS HMRC MAKING YOU AN OFFER YOU CAN'T REFUSE? THE NEW PROFIT DIVERSION COMPLIANCE FACILITY

On 10 January 2019 HMRC [announced](#) a new initiative for multinationals: the Profit Diversion Compliance Facility (the "PDCF").

The PDCF is stated to be targeted at taxpayers who have adopted cross-border arrangements which divert profits from the UK based upon inaccurate facts or the incorrect application of OECD transfer pricing guidelines. Those taxpayers should, HMRC believes, be subject to the diverted profits tax and civil and criminal penalties.

Under the PDCF, HMRC is offering taxpayers a deal: if you provide full disclosure of your arrangements, calculate what the correct tax result should have been and pay the tax in full, then HMRC will spare you the time and cost of a full enquiry and any penalties should be at the lower level applicable to a voluntary disclosure.

This briefing considers three critical questions. Who is HMRC really targeting with the PDCF? Which taxpayers should be using it? And how should they go about doing so?

WHAT IS "PROFIT DIVERSION"?

The UK introduced a "diverted profits tax" ("DPT") in 2015 which (broadly) applies to:

- (i) UK companies (or UK permanent establishments of foreign companies) that use entities or engage in transactions which divert profits from the UK but lack economic substance; and
- (ii) foreign companies carrying on activities in the UK in a way that is designed to avoid a UK permanent establishment,

in each case where the effect is to reduce UK taxable profits.

The DPT operates as a corporation tax anti-avoidance rule, but it is technically a separate tax and therefore cannot be relieved by tax treaties. It applies at a higher rate than corporation tax (25% for non-banks and 33% for banks), has

Key issues

- The PDCF allows MNEs with historic and ongoing non-compliant transfer pricing and DPT positions to resolve their position efficiently.
- However, what HMRC considers to be "non-compliance" is potentially open for debate and making use of the PDCF will necessarily be expensive and labour-intensive.
- MNE taxpayers should consider their position carefully before registering under the PDCF.

a greatly accelerated timescale for payment and provides HMRC with a number of significant procedural advantages over the usual process for corporation tax enquiries.

The DPT was famously heralded by the then-Chancellor as a "Google Tax" but has apparently not in fact been applied to Google. Rather, publicly available materials suggest that it has been used by HMRC to obtain additional leverage in what would historically have been standard transfer pricing disputes.

Taxpayers who are potentially subject to the DPT are supposed to notify HMRC. The PDCF announcement suggests HMRC believes that a material number of taxpayers are not doing this. Indeed it goes further, stating that some taxpayers are taking transfer pricing positions that are contrary to the facts or to the OECD guidelines.

WHICH TAXPAYERS WILL BE AFFECTED?

The HMRC PDCF Guidance lists a number of "risk indicators" for profit diversion and "common misconceptions" on the application of the DPT. From this, we can identify several categories of taxpayer that HMRC would view as being subject to the DPT, but which will not have notified HMRC:

- Taxpayers who have intentionally taken incorrect positions. For example, asserting on a tax return that a payment to an offshore affiliate represents arm's length consideration for services provided, when the taxpayer knows that the affiliate does not provide any valuable services. This would be a clear breach of tax law and if the behaviour in question was dishonest then it could also amount to a crime.
- Taxpayers who have taken incorrect positions, but accidentally rather than deliberately. An example would be a structure established several years ago involving payment to an offshore affiliate for valuable services which it actually provided. However, changes over time in personnel meant that the affiliate ceased to provide valuable services, but the change was not known to tax personnel and therefore current tax returns are incorrect. It (of course) follows that taxpayers may fall in this category without realising it.
- Taxpayers who are intentionally taking transfer pricing positions which they believe are legally sound but where the taxpayer is aware that HMRC takes a contrary view. HMRC takes several positions on transfer pricing that are widely questioned as a matter of law, such as asserting that changes to OECD guidelines are merely "clarifications" and so have retrospective effect, inappropriately using hindsight when applying transfer pricing methodology and applying OECD guidelines which are limited to one particular product or sector to other products or sectors. Taxpayers are not required to assess themselves to the DPT on the basis of legal positions they believe are incorrect.
- Taxpayers who take technical positions on the DPT which differ from HMRC's position. These might be particular points of interpretation, such as considering whether a structure can reasonably be assumed to have been "designed" to achieve a certain tax outcome. However, these might also be more fundamental, such as arguing that the DPT is contrary to EU law (for which see our previous [briefing](#)).

The HMRC PDCF Guidance does not distinguish between these cases: however it is important that any taxpayer contemplating using the PDCF considers very carefully which category they might fall in.

HOW DOES THE PDCF WORK?

The process for registration is straightforward – a UK member of the MNE group must complete a short form. After registration, the MNE has 6 months (or longer if agreed) to submit a Report setting out any additional tax due in relation to the relevant profit diversion arrangements and make payment of any additional tax. HMRC will then review the Report and aim to respond to the Proposal within three months.

The Report must set out the facts relevant to the arrangements, describe the approach to establishing the facts and reference how the facts are evidenced. The HMRC PDCF Guidance suggests that establishing the facts could be a significant undertaking including interviewing staff and customers and reviewing contemporaneous emails and documents. The evidence does not need to be provided with the Report, but should be referenced and may be requested by HMRC. The Report should also include detailed tax technical analysis (which can be submitted on a "without prejudice" basis) for each tax risk identified by the facts. This would almost certainly cover transfer pricing and the DPT, but might also encompass issues including residence, hybrids, withholding tax and CFCs. The taxpayer must then evaluate the behaviours that have led to any underpayment of tax and assess the penalties that arise. The Report should include a calculation of the estimated tax, interest and penalties due and a description of any changes being made to transfer pricing or structural arrangements going forward. A senior responsible officer must then submit a declaration in connection with the entire Report.

If the Report is accepted, HMRC will typically seek to close the relevant accounting periods and commit to not issuing DPT Preliminary Notices for the relevant periods.

WHAT ARE THE BENEFITS OF USING THE PDCF?

HMRC is clear that the PDCF does not offer any special treatment with respect to penalties. However, if the MNE complies with the terms of the PDCF, HMRC will treat the disclosure as "unprompted". Thus, depending on the behaviour that has led to additional tax being payable, the penalties could be significantly reduced and in some cases eliminated entirely. Unlike other disclosure facilities (such as the Liechtenstein Disclosure Facility), there is no guarantee of fixed penalties. There is also no immunity from criminal investigation.

HMRC sets out that one of the benefits of the PDCF is the ability of the MNE to manage internally the process of establishing the facts and presenting the tax analysis. There is also the possibility that the taxpayer will benefit from a faster, more efficient and less intensive approach to resolving its position. HMRC does not focus on the significant costs that will necessarily be incurred by a taxpayer in properly complying with the terms of the PDCF.

WHAT ACTIONS SHOULD YOU TAKE?

The PDCF is unlikely to be attractive to taxpayers who believe their current transfer pricing arrangements are fully compliant, even if they suspect that HMRC may take a different view.

The PDCF will be most attractive to taxpayers who are concerned that their current transfer pricing arrangements are, whether intentionally or unintentionally, contrary to the correct application of the law. HMRC has also indicated that it may send letters to "high-risk" MNEs suggesting that they register under the PDCF – the clear implication being that if they then do not make use of the PDCF they will be subject to a full enquiry. The information available on DPT enquiries to date suggests that HMRC can adopt an aggressive approach. Therefore, taxpayers who receive a PDCF letter from HMRC or have residual concerns about the extent to which their transfer pricing arrangements are compliant, will wish to consider carefully whether to make use of the PDCF. This might include an initial, high level investigation before registering, given that registration marks (in effect) the point of "no return".

It is important that any investigation carried out for the purposes of submitting a Report under the PDCF, and indeed any preliminary investigation carried out prior to registering, is comprehensive. Ensuring the full engagement of all stakeholders within the MNE will be key and care should be taken, where appropriate, to maintaining legal professional privilege both with in-house and external advisers (noting the difficulties that can arise, as was the case in the recent decision in *The RBS Rights Issue Litigation* [2016] EWHC 3161 (Ch) - see our previous [briefing](#)).

All MNEs should consider if they have risk areas in relation to the DPT and transfer pricing. If they do, then an initial investigation should be undertaken to properly assess the position. Any MNE receiving a PDCF "invitation" should certainly undertake at least an initial investigation before declining. Taxpayers who are confident in their application of the law should not be troubled by this HMRC initiative.

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