13 February 2018

Global Tax Alert

UK Tax Authority begins second round of enquiries on Diverted Profits Tax

Summary of Diverted Profits Tax to date

Figures released by the United Kingdom (UK) Tax Authority (HMRC) in September 2017 showed it raised £281m (approx. US$[1]388.5m) as a result of the UK Diverted Profits Tax (DPT) legislation in the tax year 2016/17, about half from 14 DPT charging notices. The balance was from corporation tax from transfer pricing (TP) adjustments or spontaneous "behavioural change" across the large business population triggered by the introduction of the DPT.

These figures do not take account of the further DPT yield in December 2017, which was the deadline for HMRC to issue DPT charging notices for December year-end businesses that notified a potential DPT liability for the first year covered by the 2015 DPT legislation.

Second phase of DPT

HMRC's DPT activity has now moved on to a second phase. This is a twin track follow-through of charging notices already issued, with a view to collecting further corporation tax from TP adjustments or confirmation of the DPT already charged and paid, coupled with pursuit of businesses who did not notify potential DPT liability in respect of 2015 through an extended Initial Risk Review (IRR) process. There will be a particular focus in the second phase on smaller, mid-sized, businesses.

EY Global Tax Alert Library

Access both online and pdf versions of all EY Global Tax Alerts.

Copy into your web browser:

www.ey.com/taxalerts

HMRC has increased its dedicated DPT resource to take on this work. From an initial 50-55 staff, resources were increased in 2017 by four additional regional multidisciplinary DPT teams each of 15 staff, each handling six to seven large and mid-sized DPT investigations. The relevant HMRC teams were allocated a further slice of "Spend to Raise" funding in the Autumn Budget, which is expected to fund an additional 20+ officials over the next two years.

Where will HMRC focus its attention?

There are already 100+ DPT cases ongoing and hundreds more "Large" and "Mid-Sized" cases will now be reviewed and enquiries launched in the next 12 to 18 months. Market intelligence suggests a particular focus on Mid-Sized cases, and on sectors including life sciences, oil and gas, and mining and metals. HMRC is also investigating a number of captive insurance arrangements within large groups.

As a reminder, DPT is aimed at groups that use what HMRC sees as contrived arrangements to circumvent rules on permanent establishment (PE) and transfer pricing. DPT is intended to address two broad situations:

- A UK company (or UK PE of a foreign company) uses entities or transactions that lack economic substance to exploit tax mismatches to reduce effective taxation to below 80% of rate otherwise payable in the UK.
- A person carries on activity in the UK in connection with the supply of goods, services or other property by a foreign company and that activity is designed to ensure that the foreign company does not create a PE in the UK.

The DPT legislation contains some specific exemptions, most notably for small and medium-sized companies (SMEs), so companies with fewer than 250 employees and a turnover of less than €50m (or a balance sheet total of less than €43m) are exempt.

IRR process and information requests

In carrying out an initial sift of potential DPT cases, HMRC is likely to be looking at multinational groups where the UK is a key market and considering where the profit/value drivers are located. It will consider what it knows about the transfer pricing – i.e., how is each entity rewarded and what is the transfer pricing for each UK transaction. Particular risk factors it might consider would relate to the presence of low tax companies, significant cross-border payments, the location of senior group personnel in the UK, and any indications of risk it might glean from the group's tax strategy.

For cases where HMRC takes its risk assessment further, the IRR process will involve not just desk-based reviews but also a largescale issue of information requests. It should be noted that HMRC's information powers in respect of DPT are not linked to any formal opening of an enquiry, so HMRC is able to issue information notices "for the purpose of checking the taxpayer's tax position," which could include a risk review. The issue of these information requests will be centrally managed within HMRC and groups are likely to see a wave of requests from summer 2018 as the IRR process gets into full swing. Informal information requests are likely to be followed up rapidly by formal notices as HMRC is under time pressure to complete any DPT review and issue DPT charging notices against a statutory deadline.

DPT enquiries

Where HMRC sees DPT risk it is likely to launch an in-depth and fast moving enquiry which in our experience is exceptionally resource intensive for both sides. The enquiries are typically focused on a functional/factual profile covering both TP and PE risk as well as a potential diversion of profits. Typical information requests can include a multi-sided value chain enquiry, a review of key contracts, the review of source materials (including emails and other relevant documentation), functional interviews with key personnel and also third-party information.

HMRC's determination to secure both yield and behavioral change from DPT is borne out by the targets it has set its staff in this area. The Budget 2017 Red Book forecasts DPT receipts at £200m in 2017/18 and £300m in each of the following two years, i.e., a doubling of the 2016/17 DPT yield. In addition, HMRC is shifting its internal targets to incentivize officers to score compliance yield "upstream," with a large proportion of overall Large Business yield of around £8bn per year expected in future to be raised before returns are filed. DPT driven TP adjustments and behavioral change will likely form a large part of this.

In contrast to a traditional corporation tax enquiry, the DPT legislation shifts the balance of power very significantly in HMRC's favor. In addition to fewer constraints on its information powers, HMRC has the advantage in a DPT case of being able to issue a DPT charging notice which requires tax to be paid upfront, with no postponement or right of appeal at that point, acting as a strong incentive for the business to concede TP adjustments not only for current but also previous, in-date, years. DPT also brings an extended penalty regime, including penalties for failure to notify potential DPT liability, as well as the threat of penalties for carelessly (or deliberately) incorrect returns and potential Senior Accounting Officer penalties if accounting arrangements are found to be defective.

Why should businesses act now?

Timely engagement and the provision of relevant and appropriate information to HMRC is crucial, both at the IRR and the DPT enquiry stages. Given the resource intensity of a full blown DPT enquiry, a business subject to an IRR will want to consider engaging early with HMRC with a view to securing a low risk conclusion.

Businesses will want to bear in mind that, with HMRC's focus on high risk cases, there is a considerable and lasting benefit in agreeing with HMRC that they are low risk.

Endnote

1. £1 = US$1.38, Data from Morningstar on 9 February 2018.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (United Kingdom), London

- Mat Mealey, *International Tax Services* mmealey@uk.ey.com
- Ben Regan, *Transfer Pricing* bregan@uk.ey.com
- Geoff Lloyd, *Tax Policy and Controversy* glloyd@uk.ey.com

Ernst & Young LLP (United Kingdom), Glasgow

- Johnston Orr, *Tax Controversy and Risk Management* jorr@uk.ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

EYG no. 00778-181Gbl

1508-1600216 NY
ED None

ey.com