# The ever-growing challenge of managing tax disputes and tax risks

**December 2016**

By any measure, 2016 has been a year of considerable surprise and change, whether relating to referendums, elections or multilateral instruments. Some continuity can be found, however, in the government's continued focus on measures designed to tackle tax avoidance and deal with tax disputes.

The drip feed of judicial decisions in long running tax cases such as FII [2016] EWCA Civ 1180 has continued to garner headlines, not least given the potentially huge sums involved. However, the historic nature of these claims, coupled with the prospect of Brexit bringing the curtain down on EU remedy based actions, means that the newer rules and proposals are most likely to be relevant to taxpayers and their advisers going forward. Of these, three areas stand out:

- the new rules on partial closure notices (and the consequences for disputes where multiple taxpayers have similar matters at stake);
- the additional funding for HMRC to investigate and litigate 'avoidance' (especially the resulting focus on transfer pricing and diverted profit tax issues); and
- just in case anyone had relaxed because their own tax affairs were in order, the new criminal offence of failing to prevent the facilitation of tax evasion.

## Partial closure notices

Schedule 19 of Finance Bill 2017 contains a series of amendments to existing tax legislation that, when enacted, will introduce 'partial closure notices' (PCNs). These were originally proposed in a consultation in 2014 (see www.bit.ly/1vPgMiB and are designed to allow discrete matters in an enquiry to be concluded while leaving any other issues open. As many taxpayers said in response to the original consultation, the timely resolution of matters in an open enquiry is something to be welcomed, so it's perhaps helpful that the new rules will apply both to existing and future enquiries (see www.bit.ly/1FHMXep).

Procedurally, the new rules will allow HMRC to issue a PCN in relation to 'any matter' that is subject to an open enquiry. Responding to one of the principal criticisms of the original proposal, taxpayers will also be able to ask HMRC to issue a PCN, or apply to the tribunal to order HMRC to issue a PCN in relation to a particular matter. In each case, issuing a PCN for a particular matter has broadly the same effect as issuing a normal closure notice for a whole return - the amendments to the taxpayer's return must either be accepted or contested through the tribunal and further information requests or questioning in relation to the matter covered by the PCN are effectively stopped.

In principle, therefore, the PCN rules have considerable scope to accelerate specific matters to formal resolution before the tribunal. That is likely to be helpful if there is a narrow technical issue at the heart of the dispute, including the 'all or nothing' sort of issues that HMRC's litigation and settlement strategy makes clear can't be compromised (see www.bit.ly/1iWjIYA), or if the relevant fact pattern has been agreed. However, 'HMRC will issue PCNs in enquiries where a customer's tax affairs are complex or where there is avoidance or large amounts of tax at risk', suggesting that at least two of the concerns raised previously remain.

First, as a practical matter, it is unclear how tax will be levied fairly in relation to a specific 'matter' in isolation from the rest of the taxpayer's affairs for the year in question. The policy costing documents anticipate 'earlier payment of tax, interest and penalties as elements of cases are closed earlier'. Particularly if PCNs are to be used for complex matters, the quantum of tax paid (or repaid) before the rest of a return is determined may be limited (unless taxpayers simply settle).

Second, HMRC seems likely to be the main beneficiary of the new rules. The new PCN rules will only be used where HMRC and the taxpayer don't agree that a matter should be accelerated through a PCN (or else why not use the existing rules that allow matters to be referred to the tribunal jointly?). Procedurally, a taxpayer must persuade the tribunal that HMRC does not have 'reasonable grounds' not to issue a PCN before the tribunal will order HMRC to do so. In any event, the taxpayer may see little practical advantage in accelerating a matter, given the likely delay before HMRC made any repayment.

By contrast, HMRC, which has broader obligations to consider tax 'at risk' generally, may want to accelerate a matter in a dispute with a particular taxpayer that could have implications for other taxpayers with open enquiries. Given its knowledge of different taxpayers' positions, HMRC will be better able to choose which taxpayer (and matter) to take to the tribunal using a PCN. This in turn may result in the tribunal determining matters subject to PCNs on the most HMRC friendly sets of facts. HMRC expressly anticipated in the original consultation document that PCNs could be used to generate a 'decision' that forms the basis for the issue of follower notices (and subsequent APNs).

These concerns may be addressed in the promised guidance and the operation of HMRC's internal governance system. However, the eventual impact of PCNs on tax disputes will depend in many respects on how HMRC uses them, and the approach the tribunal takes if taxpayers seek to force HMRC to issue PCNs. Ideally, PCNs will become a two-way tool to encourage the speedy resolution of all matters in an enquiry, rather than being allowed to become a device for HMRC to force taxpayers to concede matters on a piecemeal basis or as a result of decisions against other taxpayers.

## Increased resources for HMRC investigations

Another noticeable development this year was the announcement in the Autumn Statement of additional resources for HMRC to investigate and bring to litigation perceived avoidance. Following on from the investment in 2012, the practical consequence of this for many corporate taxpayers is likely to be a renewed focus on transfer pricing arrangements, both past and present.

In many respects, that's perfectly understandable: the OECD has been vocal about the level of 'lost' revenue globally and a key driver for the BEPS project was the elimination of non-taxation. However, experience from the significant number of enquiries involving transfer pricing issues that we've seen this year suggests it will be a more intense process than many taxpayers have previously experienced.

Three practical points are worth bearing in mind.

First, transfer pricing investigations are now likely to encompass not just CFC and transfer pricing issues, but the diverted profit tax (DPT) rules too. DPT is already a particular focus for HMRC. As Jim Harra told the Public Accounts Committee in October, HMRC has 'identified about 100 high-risk cases'; and this is something that's likely to increase as 2017 sees the deadline for the first round of enquiries since the introduction of DPT in 2015. If there is an EU jurisdiction involved, the elephant in the room remains the potential for a state aid investigation, which means that taxpayers' technical arguments and evidence need to be carefully considered from a number of different perspectives (and jurisdictions).

Second, the international nature of these enquiries has meant greater scrutiny of the evidence for any proposed split of operations or value between jurisdictions. Leaving aside the potential for a mutual agreement procedure under the relevant double tax treaty (or potentially Brexit-proof EU Arbitration Convention), the more immediate concern has been what does or does not have to be handed over, particularly legally privileged materials. For instance, in a dispute about the management and ownership of IP, a taxpayer may want to keep documents created for the purpose of defending that IP in third party litigation confidential from HMRC. (This is not because the taxpayer isn't cooperating with HMRC, but to mitigate the risk that its third party adversary in the IP litigation alleges the documents are no longer 'confidential' and so not privileged.) HMRC's 2013 guidance on its litigation and settlement strategy accepts that not handing over privileged material should not be taken as non-cooperation (see page 25 of the commentary at www.bit.ly/1BwCkJz). However, in line with non-tax investigations by other major regulators, that is a principle that can need practical illustration to avoid misplaced suspicion.

Third, looking beyond just transfer pricing based enquiries, any settlement will need to take account of potential penalties. Reflecting both HMRC's more robust internal governance and public criticism of past settlements, the starting position can seem to be that the taxpayer has to demonstrate why penalties are not payable (rather than HMRC demonstrating that they are). That can be a difficult threshold to get over in practice at the closing stages of an enquiry, unless thought had been given at the outset to ensuring that the evidence provided to HMRC covers issues relevant to potential penalties.

## New criminal offence for failure to prevent facilitation of tax evasion

A third significant development in 2016 was the confirmation that the government will introduce a new corporate criminal offence for the failure to prevent the facilitation of tax evasion. This is expected to be enacted in early 2017 and come in to force later in the year. As has been reported previously, the offence is closely modelled on the Bribery Act 2010; and provides that a 'relevant body' will be liable if an 'associated person', while performing services for or on its behalf, criminally facilitates fraudulent tax evasion by a third party (whether in the UK or otherwise). It is a defence for the relevant body to have 'reasonable procedures' in place (or show that it was reasonable not to have any such procedures).

The need for criminal intent from both the underlying third party tax evader and the associated person facilitating that evasion restricts the offence to circumstances of genuine wrongdoing. However, the broad geographic scope and definition of 'associated person' mean that (practically) all large organisations will need to respond to this new risk area, regardless of their own tax risk appetite.

This is not just a set of rules for financial institutions. For instance, they can apply to both last minute adjustments to M&A transaction structures to facilitate offshore planning by individual vendors, or to supply arrangements that make sense on a regional basis but which may be weighted towards a particular (lower duty) jurisdiction. These will need to be picked up by internal procedures and considered carefully to avoid potential corporate criminal liability (and the associated reputational and financial costs).

For many organisations, preparation for the new offence is being led by internal legal and compliance teams, with input from tax specialists and business teams in the UK and globally as required. As well as helping to ensure that advice on the new rules is legally privileged, there can be real time and cost benefits – both now and on a day to day basis in the future – in adapting existing anti-bribery and anti-money laundering procedures wherever appropriate.

## 2017 and beyond

The three areas summarised above will each affect tax disputes and tax risk assessment in 2017 and beyond. Each development makes sense individually and will understandably be implemented by HMRC as a reflection of government intention (and the current political climate). Taken together, however, the overall impression is of an increasingly skewed tax disputes landscape, particularly when taken with measures introduced in previous years such as follower notices or APNs.

For the (small) minority of tax evaders or genuinely non-cooperative tax avoiders, the coordinated use of HMRC's enhanced toolkit may be appropriate. However, there remains a risk that this spills over, so as to make the UK a less attractive place for business and investment for the majority of taxpayers who look to pay taxes when due and maintain good, transparent relations with all relevant regulatory bodies (including tax authorities).

At the very least, successfully navigating the tax disputes and tax risk landscape will involve careful management of technical, evidential and reputational issues.

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