SLAUGHTER AND MAY/

CLIENT BRIEFING

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Getting Closure in Transfer Pricing and DPT Enquiries

Recent cases, including *Embiricos* and *Vitol*, have clarified the circumstances in which taxpayers can bring finality to protracted enquiries by applying to the court for the issuance of closure notices. However, the taxpayer's victory in *Vitol* has been partly superseded by amendments to the diverted profits tax rules. Practitioners should be alert to the technical and procedural challenges that can now arise in the context of enquiries that involve both transfer pricing and diverted profits tax, due to the complex interaction between the two.

HMRC enquiries can be long-drawn-out affairs. According to HMRC's published statistics, it takes, on average, nearly three years to resolve a typical transfer pricing (TP) enquiry. Concern about taxpayers digging in their heels and unreasonably drawing out the enquiry process was part of the rationale for introducing diverted profits tax (DPT) in 2015. It is perhaps ironic, therefore, that taxpayers under enquiry now worry about delay or intransigence on HMRC's part leading to forced concessions under the accelerated DPT timetable. This article explains the procedural parameters within which companies must now navigate the resolution of TP and DPT enquiries, and it highlights potential pitfalls of which advisers should be aware.

In my beginning is my end

How an enquiry ends depends, of course, on how it begins. An article published last month ("Early stage tax disputes: a practical guide" Sophie Lloyd and Rob Smith), Tax Journal, 18 February 2022) explains how disputes can start. By way of setting the scene, it suffices to recap the key points here.

Where HMRC has identified a "risk" (as HMRC case workers often term it), i.e. the possibility that a company has paid insufficient tax for a particular period, the case team may begin by asking questions without opening a formal enquiry. HMRC may be satisfied with the taxpayer's answers to its informal questions, in which case no further action may be necessary — but such cases are rare. Usually, HMRC will go on to open a formal enquiry, if the applicable time limits so permit (the normal deadline being, where the relevant company tax return has been filed on time, 12 months from the filing date).

If HMRC cannot open an enquiry for a particular period due to the expiration of the relevant time limits, it may consider making a "discovery assessment" or "discovery determination" under FA 1998 Sch 18 para 41. Whilst a "discovery" is conceptually different from an "enquiry", case law has established a low bar for making a valid discovery. Accordingly, where an issue is relevant to several tax periods, HMRC may open enquiries to the extent it is able to do so (i.e., for the later years), and issue discovery letters for the earlier years, thereafter treating them all in much the same way. As the case progresses, it is also typical for HMRC to open "protective" enquiries for later years (if the same issue may arise in those later years) as the relevant deadline for each year approaches.

Formal enquiries can be closed by a closure notice issued by HMRC under FA 1998 Sch 18 para 32, whereas an agreed resolution for years for which a discovery has been made and appealed should be finalised by means of a settlement agreement under TMA 1970 s54. The taxpayer can apply to the court (under FA 1998 Sch 18 para 33) for a direction that HMRC must issue a partial or final closure notice within a specified period.

It was hoped that the innovation of "partial" closure notices (PCNs) in 2017 would facilitate the swift resolution of enquiries. However, in *Embiricos v HMRC* [2022] EWCA Civ 3, the Court of Appeal held that HMRC cannot issue a PCN in respect of a person's domicile status without (in the absence of further information) being able to quantify the amount of tax due. Whilst *Embiricos* brings a degree of certainty and finality to the conflicting decisions in the recent trio of "domicile" cases (*Henkes* [2022] UKFTT 7645 (TC) and *Levy* [2019] UKFTT 418 (TC) being the other two), it suggests that

PCNs are most apt to be deployed in cases where two or more completely separate issues arise in respect of the same tax period and not where, in respect of a single issue, there is a threshold or gateway question that the taxpayer would like the court to determine.

About time

When DPT was introduced in 2015, HMRC's tax information and impact note described it as being designed to "counteract contrived arrangements" that erode the UK tax base. Most practitioners understood it to be exactly that: a tool for combating aggressive tax avoidance by multinationals in circumstances where the existing TP regime did not provide an adequate remedy (because of the inability to disregard or re-characterise transactions). However, that expectation has not entirely been borne out in practice. HMRC interprets the DPT provisions broadly, with the result that case teams often feel compelled to run TP and DPT arguments in parallel, especially if HMRC would otherwise forgo its ability to issue DPT charging notices as a result of missing the applicable deadlines. The problem with running "ordinary" TP enquiries (by which I mean possible pricing inaccuracies that are not the result of contrived or artificial arrangements) on parallel TP and DPT tracks is that the latter regime is, by design, an unforgiving one from a procedural standpoint. This can cause particular difficulties for the taxpayer. To explain what those difficulties are, it is helpful first to revisit the basics.

As its name suggests, DPT is all about "diverted profits": profits that, in HMRC's eyes, should be subject to tax in the UK but which the taxpayer has sought to put beyond HMRC's reach by means of contrived cross-border arrangements. To borrow a catchphrase coined by my colleague Steve Edge, DPT is "transfer pricing with added brutality". That brutality comes primarily from two key aspects of the DPT regime. First, there is the differential between the corporation tax (CT) rate of 19% and the DPT rate of 25% (which will increase to 25% and 31% respectively from 1 April 2023 onwards, maintaining the difference of six percentage points). Second, DPT operates by reference to a rigid timetable, one purpose of which is to force the taxpayer's hand.

If the company has not notified HMRC that DPT may apply in respect of an accounting period, HMRC has four years from the end of that accounting period within which to issue a preliminary DPT charging notice (FA 2015 s93(6)). The company then has 30 days to make written representations (s 94(2)), after which HMRC has another 30 days to issue a DPT charging notice, if it decides to do so (s95(2)). Once a charging notice has been issued, the company must pay the DPT within 30 days (s 98(2)). There is then a "review period" lasting 15 months (FA 2015 s101 — increased from 12 to 15 months by FA 2019). The taxpayer cannot appeal against the charging notice until the review period has ended. Nor can the taxpayer realistically pursue alternative remedies in the meantime; in the case of *Glencore Energy UK Ltd v HMRC* [2017] EWHC 1476 (Admin), the High Court rejected the taxpayer's application for judicial review of a DPT charging notice, on the grounds (to simplify rather rashly) that the DPT regime already provides sufficient rights of review and appeal. These rigid deadlines reflect one of the stated aims of DPT, namely, to discourage taxpayers from dragging their feet in TP enquiries in the hope of wearing HMRC down.

That aim is also reflected in the detailed rules concerning the calculation of diverted profits. For instance, it is an intrinsic part of the legislative architecture that no DPT charge arises to the extent that the would-be diverted profits have been taken into account in a CT assessment that has been made *before* the end of the review period: see, for example, FA 2015 ss85(4) and 85(6). Likewise, HMRC has the power to issue an amending notice to reduce the DPT charge to zero, but it can only do so *during* the review period (s 101(4)).

Therefore, where DPT is in play in the context of a TP enquiry, the taxpayer will usually be keen to resolve the issue by means of a TP adjustment which has the effect of eliminating any diverted profits — and this must be done within the applicable deadlines. This is where the interaction between the two regimes poses unique challenges, which are illustrated by the recent case of *Vitol Aviation Ltd v HMRC* [2021] UKFTT 353 (TC).

Flying on empty

The story of *Vitol* began with an application for a new advance pricing agreement (APA) in 2016. Discussions with HMRC in connection with the APA application led to enquiries into the company's tax returns for 2016 and later accounting periods, and DPT charging notices were issued on a "protective" basis. After extensive engagement and correspondence, HMRC proposed a TP adjustment that would have the effect of taxing any diverted profits, which it considered to be compliant with its Litigation and Settlement Strategy. However, in its letter summarising the proposed basis for settlement, HMRC also made extensive information requests, on the grounds that further information was required to determine more precisely the amount of tax payable. Having complied with the requests as fully as it considered reasonable — and having offered to make arrangements for the review of confidential documents which it was unable to provide in the requested format — Vitol asked HMRC to issue closure notices to reflect its proposed settlement. However, HMRC refused to issue such notices, because it believed critical information remained outstanding.

Vitol then applied to the First-tier Tribunal (FTT) for a direction to issue closure notices, arguing that the outstanding information requests fell into two buckets: those which could not be provided and those which were irrelevant to determining the issues. The FTT found that Vitol had already provided sufficient information to enable HMRC to make an informed judgement on the matter, and that any lack of responses to the few remaining information requests did not constitute reasonable grounds for refusing to issue a closure notice. The FTT directed HMRC to issue the requested closure notices accordingly.

HMRC had argued that permitting Vitol to force it to issue closure notices, thereby resolving the enquiry on a TP basis, would have the effect of undermining the purpose of the higher DPT rate as a deterrent to aggressive tax avoidance. However, the FTT was unpersuaded by that argument. With reference to a statement made by the economic secretary to the Treasury in connection with the enactment of the DPT rules, the FTT judged that the DPT legislation was intended to have the effect of incentivising TP adjustments – which is precisely the outcome that the taxpayer was seeking to achieve by requesting the closure notices. Indeed, that view is consistent with statements made by HMRC before and after the enactment of DPT, which pointed to the value of the new tax being seen in an increase in CT receipts arising from TP adjustments, and not from the payment of DPT itself.

HMRC has not appealed against the FTT's decision. Instead, the law has been changed. FA 2022 amends FA 2015, with effect from 27 October 2021, to specify that HMRC cannot issue a CT closure notice in respect of profits that are subject to a DPT charge until *after* the review period ends: thus removing the company's ability to require HMRC to issue a closure notice in circumstances such as Vitol's. Under FA 2015 Part 3, the taxpayer was formerly empowered to amend its CT return to eliminate any diverted profits within the first 12 months of the 15-month review period; the FA 2022 amendments also extend that deadline to 30 days prior to the end of the review period.

This serves to shine a spotlight on the question of what happens if the parties cannot reach resolution before the end of the review period, but subsequent engagement reveals a path to an agreeable TP settlement. Can the parties still close the case by themselves, or must they leave it to the courts? HMRC cannot issue an amending notice to eliminate the DPT charge after the review period has ended – but if it wished, could it nonetheless achieve the same result by entering into a settlement agreement? To my knowledge, there is no clear authority on this point, and there would appear to be no technical bar to such action. However, I suspect HMRC may feel wary about agreeing to a contract settlement on the basis of a TP adjustment in circumstances where, as a technical matter, DPT could still be in point. It may therefore come down to whether or not the taxpayer can persuade HMRC (or, ultimately, the courts) that the gateway conditions for DPT were never met in the first place; in other words, that it should have been solely a TP enquiry all along.

Diversion ends

For the reasons explained above, the interaction between the TP and DPT rules means that the parties must operate within the following narrow parameters.

1. HMRC cannot issue a TP closure notice *during* the DPT review period.
2. A TP closure notice issued *after* the end of the review period would *not* have the effect of reducing the amount of any diverted profits under the DPT rules.
3. In any case, HMRC cannot issue a DPT amending notice (to eliminate the DPT charge) *after* the end of the review period.
4. Consequently, if, *after* the end of the review period, HMRC were to be inclined to agree settlement on a TP basis, it may feel wary about doing so unless it is satisfied that the gateway DPT conditions were in fact never met.
5. The taxpayer can amend its CT return to eliminate any diverted profits, but only during the first 14 months of the DPT review period.

So, where does this leave the taxpayer who would like to resolve the enquiry on a TP basis, but finds itself caught in the headlights of the DPT juggernaut?

Where time permits, the parties may be able to settle the matter on a TP basis within the deadlines set out above. Even though, in this scenario, HMRC should be happy to issue a CT closure notice, it would be unable to do so during the review period, and it cannot end the review period early in order to issue a closure notice because it would then be unable to amend the DPT notice. So, the taxpayer would need to amend its CT return to reflect the agreed settlement, which (by eliminating the relevant profits from the DPT calculation) then permits HMRC to reduce the DPT charging notice to nil, and the parties can then agree to terminate the review period early. The effect, both actual and intended, is that the taxpayer must, by amending its own self-assessment return, forgo its right to appeal. Whilst that is justifiable, the ramifications for correlative relief or the mutual agreement procedure (MAP) are less clear and could be perceived to result in some unfairness to the taxpayer. For example, the taxpayer may have been content to agree

the TP settlement in the expectation that correlative relief should be available, but would wish to pursue a domestic appeal in the event that such relief were to be refused; that option would be unavailable in this scenario, where the DPT timeline has bounced the taxpayer into making a non-appealable self-assessment.

Where the enquiry cannot be settled in time, the taxpayer must choose one of two unattractive options. The taxpayer could pay additional tax at the CT rate (instead of the DPT rate) by amending its own CT return, before the 14-month deadline, to bring into account the profits that HMRC has alleged to be "diverted" profits in the DPT charging notice. However, the amount specified in the charging notice is typically a rough estimate of the highest amount HMRC considers it could reasonably seek to pursue in litigation, which would normally be far more than the taxpayer is prepared to settle for, even after allowing for the differential between the CT rate and the DPT rate — and, again, the taxpayer could not appeal against its own self-assessment. Alternatively, the taxpayer could stick to its guns, allow the DPT deadlines to pass without amending its CT return, and hope either to persuade HMRC that DPT is simply not in point (which should, in my view, enable HMRC to enter into a contract settlement if agreement can be reached further down the line) or take its chances in litigation. That is a similarly unattractive course of action, even for a taxpayer that considers itself to be in a strong position on the facts, especially given the difficulty of litigating complex TP issues.

For the taxpayer to be thus caught between a rock and a hard place may seem justifiable in circumstances where its position is unlikely to be tenable as a matter of fact and law, or where it is the taxpayer who has held up the progress of the enquiry by failing to engage collaboratively in the process of fact-finding and negotiation. It would, however, be a harder pill for the taxpayer to swallow if, in the context of what I have termed an "ordinary" TP enquiry, a lack of focused co-ordination on HMRC's part were to result in the unnecessary issuance of a "protective" DPT charging notice and a consequent race to reach resolution in time for both parties to take the necessary procedural steps to eliminate the DPT charge before the review period ends. Indeed, this was the concern expressed by the FTT in *Vitol*: that not permitting the company to seek closure notices during the review period unfairly disadvantages taxpayers who, perhaps through no fault of their own, happen to have entered the DPT review period.

In all of these scenarios, the onus is on the taxpayer and its advisers to be alert to the complexities and to plan accordingly. It is vital to factor in the time taken by the HMRC governance process. Whilst the resolution of smaller matters can be signed off by the case team itself, the settlement of a high-value and/or complex TP and DPT enquiry may need to be approved first by HMRC's regional governance board and the Penalties Consistency Panel, then by the Tax Disputes Resolution Board, and lastly by a panel of three Commissioners, chaired by the Tax Assurance Commissioner. The whole process can take a matter of months, and the taxpayer would not wish to take the step of amending its CT return to reflect the agreed settlement until the issue has been approved at all levels. It is therefore advisable for the parties to seek to resolve the issues and agree the proposed settlement at least several months prior to the end of the DPT review period, to allow sufficient time for the governance process.

Where focus is lacking or things do not go to plan, it is understandable that the taxpayer may feel aggrieved by the "pay now, argue later" approach. Of course, HMRC might counter that what looks like a bug is actually a feature: that handcuffing the taxpayer to the table and then going looking for the key invests proceedings with a fitting sense of urgency. However, it is not clear that the "good cop" of TP and the "bad cop" of DPT will extract more confessions now that they have teamed up. Given how the law and HMRC's practice have evolved in this area, it seems more likely that there will be a significant increase in the number of cases that are referred to the competent authorities under the MAP or which, ultimately, may fall to be decided by the courts — a step change which we are already seeing in practice.

In the meantime, perhaps while a MAP works its way through, preliminary DPT notices will keep arriving each year like birthday cards (except that any "present" has to go in the opposite direction), and will potentially cause more difficulties in reaching resolution. There has to be a better and less harsh way of protecting HMRC's position in circumstances where the TP enquiry is running on despite the taxpayer's best efforts to reach resolution.

Note: Slaughter and May (but not the author) acted for the taxpayer in the Vitol case

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CONTACT

Tom Gilliver
ASSOCIATE
T: +44 (0)20 7090 3462
E: tom.gilliver@slaughterandmay.com

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For further information, please speak to your usual Slaughter and May contact.

www.slaughterandmay.com

575 905 023