

Practice guide

How to handle HMRC transfer pricing enquiries

Speed read

Transfer pricing (TP) enquiries are becoming a commonplace challenge within the UK tax landscape. Once an enquiry is opened, it can be a difficult process to manage. The average time for resolving such enquiries is often two years or more. The management time and external adviser fees associated with enquiries are therefore typically significant. HMRC's approach to TP enquiries is governed by two policies: HMRC's litigation and settlement strategy (the overarching policy basis as to how disputes should be handled), and HMRC's TP governance (which is more operationally focused and sets out the required process and working practices). Typically, the most effective and cost-efficient risk management takes place prior to the CT return submission and the raising of a TP enquiry. This entails: conducting a regular TP policy review; raising the level of TP awareness within the organisation; incorporating TP standards into operating policies and procedures; and engaging with HMRC prior to returning the CT return submission. When responding to a TP enquiry, interactions with HMRC can make a key difference in terms of the cost of dealing with the enquiry and the outcome. Affected businesses should consider: taking specialist advice early; adopting a collaborative working approach; agreeing the action plan at the outset of the enquiry; and making every effort to keep to the agreed deadlines, including challenging the HMRC case team when its deadlines appear to be slipping.



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The context

The rapidly changing international tax environment is increasing the risk of tax disputes and in particular transfer pricing (TP) enquiries. The UK, like many other jurisdictions, has introduced a raft of rule changes following the base erosion and profit shifting (BEPS) project recommendations made by the OECD, and TP has been an important focus. The BEPS project and the OECD recommendations resulted in a raising of the bar for documentation and compliance standards, alongside a more detailed analytical framework to enable the

alignment of taxable profit with value creation across a group.

In response to these changes, the approach in the UK (and many tax authorities globally) has focused on a range of measures to combat perceived BEPS. The measures – and changes around the culture and perception of risk – are impacting all TP arrangements. HMRC and HM Treasury view TP as a key plank of the agenda in their engagement with international businesses.

The share of profits attributed to UK entities as a result of TP enquiries are increasing year on year. In 2017/18, the additional tax from TP adjustments arising from HMRC's challenging TP arrangements was c. £1.6bn, almost tripling over a five year period.

TP is now often considered alongside other measures as part of HMRC's enquiry process into positions adopted by taxpayers. Diverted profits tax (DPT) has had an important impact – both in its own right, but also because of the resulting behavioural changes. DPT has resulted in an increase in TP yields because it will often be preferable to make a TP adjustment rather than suffer a DPT charge, with the potentially increased cost and reputational impact of the latter.

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The interactions with business as a result of the introduction of DPT has also shaped HMRC's thinking around TP in other contexts. As a result of developing more investigatory based techniques, HMRC has formed a view that, in some instances, certain structures have the effect of diverting profit and are misaligned with the underlying basis of value creation. The recently introduced profit diversion compliance facility (PDCF) offers taxpayers the chance to register for a voluntary disclosure facility where there is risk of profit diversion. HMRC is endeavouring to encourage this by sending 'nudge' letters to businesses that it has profiled as being a potential risk. A detailed report is required if this facility is used, much of which will focus on TP matters; i.e. a detailed setting out of underlying operating models, and how the TP policies relate to these.

A setting out of the governance and processes of a DPT enquiry or working with the PDCF are beyond the scope of this article, but they form an important context. As we will see later on, some of the techniques developed in these areas are being brought to bear in 'mainstream' TP enquiries.

Similarly, the invoking of the mutual agreement procedure (MAP) is not considered in this article, although it may well shortly follow an adjustment made in an enquiry. That process under the auspices of double tax treaty is to resolve differences of tax authority views on the 'arm's length' pricing that should be applied.

The opening of a TP enquiry

The self-assessment regime operated by the UK requires that a submitted return is correct and complete at the time of submission. Whoever signs the UK tax return

should be satisfied that the TP arrangements contained therein satisfy the 'arm's length' principle and comply with UK law.

As TP is fully integrated into the UK corporation tax (CT) compliance process, consideration of TP risks are part of the routine CT return risk assessment made by HMRC (e.g. business risk reviews), as well as more targeted profiling informing identification of cases where there is a risk of profit diversion.

Assuming the CT return is submitted on time, HMRC ordinarily will have 12 months from the statutory filing date to raise a notice to enquire into the tax return (FA 1998 Sch 18 para 24). This period can be extended in certain circumstances and discovery assessments made.

A TP enquiry may be opened up in its own right, or as one of a number of issues (related and unrelated). HMRC has formalised governance related to the opening of a TP enquiry and this is set out below.

HMRC's policies relating to TP enquiries

There are two principal HMRC policies which provide the framework governance for HMRC's conduct of TP enquiries:

- **TP operational guidance:** The 'TP governance' (see HMRC's *International Tax Manual* INTM481030) applies from 1 April 2008 to any enquiry or potential enquiry where TIOPA 2010 Part 4 (formerly ICTA 1988 Sch 28AA) or the arm's length principle may be invoked.
- **HMRC's litigation and settlement strategy (LSS):** This sets out the principles within which HMRC handles all tax disputes subject to civil law procedures. This includes most of HMRC's compliance activity (the LSS is available to view at bit.ly/321sIWC).

The LSS is the overarching policy basis as to how disputes should be handled (an enquiry is considered as a dispute for these purposes), whereas the TP governance is more operationally focused and sets out the required process and working practices.

We have summarised pertinent aspects below.

TP operational guidance

The TP governance applies to any enquiry or potential enquiry where TIOPA 2010 Part 4 or the arm's length principle may be invoked. It seeks to ensure that each TP case is evaluated individually and that HMRC applies a consistent approach to similar cases. It also attempts to manage the resource costs for both HMRC and taxpayers, as it is recognised that a TP enquiry is a resource intensive process for both parties.

This governance frames how decisions are made by boards and panels within HMRC, and sets out the process and requirements to be followed by HMRC inspectors in the conduct of the enquiry itself.

HMRC's TP decision making bodies

The Transfer Pricing Board (TPB) makes decisions on large or sensitive TP enquiries that do not require referral to the Tax Disputes Resolution Board (TDRB), which deals with the largest and most sensitive cases. The TPB also makes recommendations to the TDRB about TP risks that fall within the TDRB's remit. The TPB is supported by the Transfer Pricing Panel (TPP), which makes decisions on TP enquiries that do not come within the TPB's remit. In some smaller cases, a single

TP expert examines the issue.

Whilst the criteria are more nuanced than a single measure of tax at stake, the TDRB (or tax commissioners) will usually make decisions on risks of £100m and above; the TPB on risks of between £25m and £100m; and the TPP on issues up to £25m (and is the decision making body on opening enquiries).

To give a sense of context, in 2017/18 the TPB considered 27 cases, and the TPP considered 158 resolution proposals.

TP enquiry process

There are three main stages to the enquiry process:

1. Selection: making sure the selection of a case is appropriate;
2. Progress: ensuring there is effective progress in a case; and
3. Conclusion: reaching the appropriate conclusion in a case.

Important factors and steps associated with the enquiry process are highlighted below.

Stage 1: case selection

A risk assessment will normally be applied by HMRC looking at particular characteristics of the company. Examples of factors considered in the TP risk assessment can be found in HMRC's *International Tax Manual* (at INTM482120). When a potential TP enquiry is identified by a case team reviewing a CT return, they are required to contact the TP unit dealing with its office. A transfer pricing specialist assigned to the case will then provide assistance in making an assessment to recommend whether an enquiry should be opened.

If it is concluded that an enquiry is justified, a business case must be prepared and submitted to the appropriate HMRC TP panel. The business case must contain background, the risk assessment work undertaken, and the reasons for and against enquiry. It also needs to include the recommendation of the customer compliance manager.

A TP enquiry must not be opened without the approval of the TP panel.

Stage 2: progress

Once the case proceeds as an enquiry, the case team will issue a formal enquiry notice. Detailed discussion and review of the TP will commence between the taxpayer and the HMRC case team.

The preparation of an action plan by the case team is mandatory for every TP enquiry. The action plan is a working document but at the outset is expected to contain:

- the timeline for fact finding, during which information and supporting documentation is obtained and interim analysis carried out;
- the period of time during which findings will be reviewed, arguments developed and views exchanged with the business; and
- the date by which HMRC expects to be in a position to prepare a resolution review and the planned date of settlement of the TP enquiry. For simple cases, this should be no later than 18 months after opening the enquiry or 36 months in complex and high risk cases.

It is recommended that action plans are drawn up in collaboration with the taxpayer and that dialogue between the parties is maintained throughout the enquiry.

To ensure the action plan is adhered to, a formal

review is to be completed by the HMRC case team and assigned TP specialist every six months. This should summarise progress and re-evaluate the tax risk. This review is submitted to the appropriate TP panel.

Stage 3: conclusion: review and settlement

When the HMRC case team and TP specialist have completed their review, it is referred to the appropriate TP panel for consideration.

The referral is by means of a written review of the case by the case team/TP specialist comprising:

- a narrative summary of the case, providing an update on the last progress review and setting out the positions of the parties;
- a recommendation by the customer compliance manager as to how the case should be settled to include the tax effect of the proposal; and
- a statement about culpability.

Taking full account of the resolution review recommendation, the TP panel or TP board will decide whether to:

- close the case without adjustment;
- settle by negotiation; or
- proceed to litigation.

Where the decision is to negotiate a settlement, the panel will authorise the case team/TP specialist to settle according to clearly defined parameters. If subsequently settlement cannot be agreed with the taxpayer, the case must be referred back to the appropriate TP panel with further recommendations for an alternative route.

Penalties

Penalties are always a consideration where adjustments are to be made, and are themselves subject to their own governance and decision making bodies. A detailed view of that is outside of the scope of this article but it is worth reflecting on the information in HMRC's TP operational guidance that sets out the specific TP context (INTM483110). The guidance reaffirms the general policy and then sets out that a penalty may be due if:

- an incorrect tax return is made and a business has been careless or negligent in establishing the arm's length basis for the return; or
- the business does not maintain the appropriate documentation to demonstrate that it has made its returns on the basis that the terms were considered to be arm's length.

Some examples are then provided which cover common situations, which include where:

- analysis has been carried out but is flawed;
- no analysis has been carried out;
- there has been no attempt to price a transaction;
- there is reliance on documentation produced elsewhere in the group but with no assessment of adequacy for UK purposes; and
- there is incorrect application of policy.

This is a complex area and HMRC requires case teams to consult with its central business, assets and international TP team when asserting a basis for penalties. Similarly, taxpayers should also seek specialist advice on their position.

HMRC's litigation and settlement strategy

The LSS is the framework within which HMRC works to resolve disputes with taxpayers. It applies to all disputes whether resolved by agreement or litigation. Dispute

has a wide meaning within the LSS and covers instances where:

- HMRC needs more information to enable it to form a considered opinion on the correct tax treatment of a transaction; and
- HMRC and the customer (or their agent) have differing views on what is the 'legally due tax at the right time' (LSS, page 4).

As can be seen, the LSS therefore applies to the TP enquiry process and is an important framing as there will often be a detailed exercise in gathering information that will not necessarily be easy to obtain. In respect of TP enquiries, the following factors can often be relevant.

A collaborative approach: Wherever possible a collaborative approach with HMRC should be adopted in respect of resolving any enquiry. As per the LSS: 'HMRC will foster a non-confrontational approach with the customer, but will not be deterred from efficient and effective dispute resolution by other means if collaboration is not forthcoming.'

A confrontational approach almost inevitably will result in a longer enquiry process and a greater use of HMRC's formal information gathering powers

Issue resolution: The resolution of a specific TP enquiry must be assessed individually. The resolution agreed must be in accordance with the tax law. Importantly, the LSS sets out that 'where there is more than one dispute between a customer and HMRC, each dispute must be considered and resolved on its own merits, not as part of any overall "package".'

This highlights an important cultural touchpoint within HMRC, i.e. a position needs to be robust in its own right. This accentuates the importance of adopting technically robust TP at the time of submission as, where it is enquired into, the resolution will be on its own merits.

HMRC's TP governance: The LSS makes clear that 'there will be tailored guidance or standard operating procedures, applicable to processes in particular area of business in HMRC's groups and directorates. This guidance should be read alongside other more detailed operational and policy guidance.' The HMRC TP governance should therefore be jointly considered with the principles set out in the LSS.

Verification: In resolving any enquiry and particularly for TP, the facts associated with the transaction will need to be complete and often verified. For TP enquiries, HMRC will often want to verify that any TP policy applied by the taxpayer has been implemented as indicated. How the verification is established will depend on the risk involved. The LSS highlights that this could include:

- what information has already been provided or is offered by the customer;
- whether the customer is able to set out details of any review they have undertaken to establish the facts; and
- whether a reputable agent or senior accounting officer has carried out an appropriate implementation review and can report to HMRC on the outcome of this due diligence activity, which may include a copy of the report and any corrective action taken.

Confirmation of the correct facts is critical to any TP analysis and will impact whether it is a supportable position. Where a group has established TP policy, it is crucial that periodic implementation reviews are conducted to ensure there have been no significant changes to the operating fact pattern on which the original TP policy was based. Where a TP policy has been applied to an incorrect operating fact pattern (which can often be as a result of changes over time), it can be extremely difficult to defend the appropriateness of a policy.

It is now very clear that HMRC is increasingly focusing on the 'primary evidence' layer and joining forces with trained tax investigators who are part of the fraud investigation services (FIS) team. Their involvement does not mean HMRC is necessarily accusing a taxpayer of fraud, but it changes the dynamic and moves the enquiry into more serious territory. Such enquiries will focus on gathering and interrogating very detailed factual evidence.

Whether to raise an enquiry: In considering whether to raise or settle an enquiry HMRC will consider multiple factors:

- the potential tax at stake in the current year or years, as well as any prior or future years, for that particular customer;
- the potential tax at stake in any year or years for other customers (including the wider impact of any HMRC intervention, such as through behavioural responses); and
- an early assessment of the potential impact (whether of the individual case or the capacity for the issue to create tax loss more widely) compared to the cost of pursuing or not pursuing the dispute.

The concept of materiality does not apply to tax compliance as it does in accounting. In practice, however, the quantum of tax at stake will have an impact on HMRC enquiry decisions. A TP position over a number of open (or openable) return years can give rise to a significant tax adjustment. Failure to analyse and support a recurring related party transaction because of its size in one individual year can be an expensive oversight.

Managing TP enquiries in practice

With an understanding of the governance framework, we now turn to looking at the management in practice of a TP enquiry.

Management of TP enquiries can take place at two key stages of the compliance process:

1. proactive risk management pre-enquiry; and
2. effectively responding to a TP enquiry

We set out below some practical considerations on approaches (this is by no means exhaustive).

Stage 1: Proactive risk management pre-enquiry

Typically, the most effective and cost-efficient risk management takes place prior to the CT return submission and the raising of a TP enquiry. The extensive fact gathering and formal procedural aspects to HMRC's TP governance often result in the enquiry process becoming a drawn out affair. It also often requires information to be gathered after the event, which may be much more difficult to prepare than had it been sourced contemporaneously. This will be often due to information retention policies, staff leaving the business and the recollection fading as to the key commercial drivers at the time.

There are certain practices that can help.

Conduct a regular TP policy review: Completing a regular TP review of the group's activities should help to identify risks, particularly where the business evolves over time and these changes require adjustments to the related policy.

This review may be in the form of an in-depth exercise that works through the value chain, functional analysis, economic analysis and conclusions on the method and appropriate pricing. Many groups will carry this out periodically (or in response to business change) and will often engage external advisors to support them.

This periodic full review should be complemented by regular monitoring reviews. Many businesses are now also creating 'defence' files where information is gathered contemporaneously that is pertinent to the transfer pricing policies; e.g. records of internal communications on operating model changes, the travel records of senior executives and so forth. Whilst this may not be submitted as a first stage response, gathering it at the time makes for a much richer set of data and significantly cuts down on the cost of producing the information down the line.

It is almost always the case that costs incurred arising from the enquiry process in terms of information gathering and analysis outweigh the costs associated with the completion of a TP review prior to the CT return submission.

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Raise the level of TP awareness within the organisation: It is extremely difficult for an in-house finance or tax function to be singularly responsible for the control of TP risk, as a great deal of the risk is driven by a detailed understanding of the constituency of the business at a granular level. Internal stakeholders can be engaged and provided with targeted high level training. This can help with the early identification of TP policy risk. Early identification of the risk will usually simplify the resolution efforts required.

Incorporate TP standards into operating policies and procedures: It is also helpful to agree roles and responsibilities with the relevant business functions in respect of the operation of TP policies and the identification of risk. Many functions can be involved in aspects of TP policy; for example, invoicing (finance), confirmation of prices (commercial functions), time spent allocations (HR) and internal legal agreements (the legal team). A sound TP operational framework will typically significantly reduce the ongoing level of TP risk, and the costs and level of resources employed to deal with a TP enquiry response that requires this information. Where a (fully documented) TP policy has been demonstrably incorrectly executed, an adjustment is almost a certainty and the question of penalties arises.

Engage with HMRC prior to returning the CT return submission: Engaging with HMRC in an ongoing dialogue around the business model of the group, the evolution of the TP arrangements and notable changes to the organisation can yield benefits around the relationship building and allow for early identification of

potential areas of interest.

HMRC is limited now in its ability to give assurances on the specifics of TP treatment outside of an advance pricing agreement. However, such dialogue will identify the headline areas of concern, and also have a bearing on HMRC's risk rating of the business as a whole, which has effect across a range of interactions.

Voluntary disclosures relating to transfer pricing errors can be made, which may have a consequence for the penalty position. This is an area where businesses should seek specialist advice.

Stage 2: Effectively responding to TP enquiry

Even with the most assiduous of risk mitigation measures, a taxpayer may still find themselves receiving notification that an enquiry will be opened. The interactions with HMRC at this stage can make a key difference in terms of the cost of dealing with the enquiry and the outcome. We have set out some experience based examples below.

Take specialist advice early: Before making any response to a TP enquiry, it is advisable to consult with an appropriate specialist. The level of complexity with TP has increased significantly and early representations can set the enquiry off in a helpful or unhelpful direction. TP specialists will normally be familiar with particular industry approaches to the TP of a transaction and can help to frame the key issues.

Inaccurate terminology or framing of a response can suggest to HMRC that a lack of rigor has been applied to the TP approach, or create confusion that takes a good deal of effort to resolve. Sometimes an initial 'high level' response can be actively unhelpful in resolving the TP enquiry, as the assertions made to HMRC preclude the application of specific TP solutions which otherwise might have been available.

Adopt a collaborative working approach: An important recurring factor in both the LSS and TP governance is the adoption of a collaborative approach between HMRC and the taxpayer. As much of the first stage of a transfer pricing enquiry is focused on information gathering, a collaborative approach can be very helpful to target the information gathering and to enable agreement on the best medium of conveying it; e.g. a presentation from a senior functional lead may be a substitute for what might otherwise be a long, narrative document. Similarly, offering to meet HMRC at the outset to agree an approach may result in a more targeted information request.

Where possible, requested information should be provided and with appropriate explanation (if required) on a timely basis. If there is a delay, it is helpful to communicate the reasons behind this to the CCM or case team contact. Normally HMRC will be sympathetic to these delays if there is positive dialogue and open communication. Constructive challenge as to whether there is an alternative set of information to provide to HMRC (which may be easier to source or more relevant) may also be entertained where the right spirit has been fostered.

It is at this stage of the enquiry that a taxpayer will feel the benefit of having gathered contemporaneously produced evidence and undertaken robust analysis at the time of the transaction. The benefit will be both in the quality of the information, but also being able to assert that it took place at the time, which could have a consequence for the perception of the analysis, and also the penalty position were an adjustment to be made.

A confrontational approach almost inevitably will result in a longer enquiry process and a greater use of HMRC's formal information gathering powers.

Agree the action plan: TP enquiries are extended affairs as there is a great deal of information gathering, technical analysis and formalised governance. HMRC is instructed to enter into a dialogue with taxpayers to collectively agree the timetable. This is an important piece of the process and businesses should make this an area of key agreement at the outset of the enquiry.

The action plan is a working document that HMRC will use to communicate to the TP panel/board on its progress. It is also a framing that can allow the tax function to communicate with internal stakeholders who will often become acutely interested in TP when it is known an enquiry is underway.

Maintain the momentum: Once the action plan is agreed, the taxpayer should make every effort to keep to the agreed deadlines – and to challenge the HMRC case team where its deadlines appear to be slipping.

This makes for a much more efficient process, particularly in the first two stages of the enquiry, as otherwise there is risk of retreading old ground as understanding of information needs to be refreshed, or differences of recollection as to agreement arise.

Given the length of time enquiries can take, it is not uncommon for personnel to change within teams – both within HMRC and in taxpayers. A well-managed enquiry can mitigate this. The duration of enquiries and change in personnel is also an important reason why all interactions with HMRC should be documented in minutes and meeting notes. HMRC will typically provide notes of meetings and these will be agreed with the taxpayer, and in any event how this is achieved should be raised and agreed on with HMRC at the outset.

Final comment

We are expecting more TP enquiries to be opened up over the next months and years. The bar has been raised and HMRC has recruited a number of specialists into its TP and DPT teams. The best mitigation measures for taxpayers take place before the enquiry but the conduct of the enquiry itself can make a very important difference to the experience and outcome.

The cost of dealing with a TP enquiry should not be underestimated – in terms both of resource and the level of effort and mental/emotional energy required. Enquiries can become high profile within a group, meaning senior personnel taking a keen interest. TP can be a complex topic and having to deal with that complexity within an enquiry context can be very demanding and raise the stakes further.

In light of the future enquiries that may be avoided or mitigated, making a choice to invest effort contemporaneously in robust TP analysis, fact gathering and risk monitoring is a sound approach. ■

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